ECONOMIC POLICY AND FULL EMPLOYMENT

by

ALVIN H. HANSEN

Littauer Professor of Political Economy
Harvard University

Whittlesey House
McGRAW-HILL BOOK COMPANY, INC.
New York : London

ECONOMIC POLICY AND FULL EMPLOYMENT

SECOND PRINTING

The quality of the materials used in the manufacture of this book is governed by continued postwar shortages.

PUBLISHED BY WHITTLESEY HOUSE

A Division of the McGraw-Hill Book Company, Inc.

PRINTED IN THE UNITED STATES OF AMERICA

To My Wife

Preface

A BOOK published in the year 1947 on *Economic Policy and Full Employment* is likely to encounter the criticism that no cognizance is taken of the immediate danger—inflation. Chapter I of this book is devoted to the inflation problem. And in several of the succeeding chapters the problem of maintaining stability comes up for discussion. In our modern, highly complicated economic order we are continually in danger. It is not easy to keep the system in balance.

We are compelled continually to keep our hand on the throttle in order to ensure an adequate, but not excessive, aggregate demand. That involves not only monetary and fiscal controls, but also, among other things, a balanced wage-and-price policy, control of monopoly, promotion of high productivity, technical progress, and, above all, social unity and cohesiveness. Stability, maximum production, and full employment are not easily achieved goals. We are perhaps out of the kindergarten stage, but we still have a long way to go.

Strangely enough, there is an amazing number of persons who are adverse to "looking ahead" when it comes to public policy questions. Why worry about full employment when the immediate problem is inflation? Not a few leading editorials and articles are devoted to this theme. In social engineering many of us are still in the stage of the primitive savage who sees no need in summer to lay up stores for the winter. Sufficient unto the day is the evil thereof. To an incredible degree public policy in all advanced countries is guilty of improvisation from day to day. It requires long planning ahead to be prepared to meet a head-on depression. No modern nation has adequately undertaken such planning. Yet we know, as certainly as we know anything, that in a few years this problem will be upon us. Unprepared, we improvise on the spot, and the result is waste and inefficiency. That is not a wise procedure. Yet it is precisely the procedure

of those who are concerned only with the problems of the moment. It is just now while the outlook for prosperity and employment is favorable that the President and Congress should state clearly and precisely what steps are intended to be taken to avert a slump.

In a real sense, the problems of the moment are also the problems of the long run. Inflation now will bring devastating collapse later. Planning for stable and high levels of employment and production must first and foremost concern itself with the problem of stability.

Part One is devoted to introductory chapters dealing with the current danger of inflation and the general problem of social and economic planning In Part Two I consider some general concepts which I hope will prove useful aids to the chapters that follow. Part Three presents what I trust may be a convenient short account of the various employment programs recently announced in five leading democracies. I was myself surprised, as I got into it, to find how illuminating the comparisons and contrasts proved to be. In Part Four, I present my own views of the basic policies needed for full employment. Part Five is devoted to a critique of some current proposals of which interest-free financing is perhaps the most conspicuous. Finally I consider some of the problems of managing a full-employment economy—inflation risks, the difficulties of maintaining equilibrium, and debt management.

This book may be regarded as a companion volume to my *Fiscal Policy and Business Cycles* published 5 years ago. While not textbooks in the ordinary sense, both books are intended for the students of economics in universities and colleges as well as for the serious general reader who is interested in contemporary economic analysis and policy.

Permission has kindly been granted to use parts or all of a few articles or addresses published elsewhere. These include: "Must We Have Post-war Inflation?" *Commercial and Financial Chronicle,* Nov. 1, 1945; "Social Planning for Tomorrow," *The United States after War,* Cornell University Press, 1945; "Wages and Prices: The Basic Issue," *The New York Times Magazine,* Jan. 6, 1946; "Hayek's Road to Serfdom," *The New Republic,* Jan. 1, 1945; "Some Notes on Terborgh's Bogey of Economic Ma-

turity," *Review of Economic Statistics,* February, 1946; "Sixty Million Jobs," *The New Republic,* Sept. 17, 1945; and "Inflation," *The Yale Review,* Summer, 1946; the last four being reprinted as appendixes.

I again wish to express deep appreciation for the facilities made available by the Graduate School of Public Administration, Harvard University, and for the stimulus of frequent discussions with students and colleagues. My sincere thanks and appreciation are also due Miss Esther Smoot for efficient help in preparing the manuscript for the printer.

ALVIN H. HANSEN

Contents

PART ONE

INTRODUCTORY

Chapter I

Inflation Dangers Ahead[1]

PLANNING for full employment and maximum production involves, among other things, planning for stability. An economy that experiences violent price fluctuations cannot be an economy of high and stable levels of employment.

Thus we must first of all face the inflation problem. But it would be folly to stop there. The inflation danger must be met, but met in a manner that gives promise of stability and full employment beyond. It would do no good to cure inflation by means that could only ensure deflation and unemployment. We need to find a middle course, to maintain a balance between inflation and deflation. In no area is this need more conspicuous than in the wage-price policy field. What is needed is to hold the car in the middle of the road and to keep it moving. Full production is no less important than stability.

The situation under the new OPA law is serious. Yet a postwar inflation is not inevitable. We are indeed confronted with a difficult period of temporary war-created scarcities. This is an inevitable consequence of the war. Under the operation of purely automatic forces, this situation would create an inflation no matter how the war had been financed. But the manner in which the war was financed also matters. We are confronted not only with war-created scarcities, but also with wartime accumulations of liquid savings. These, on top of a high current income, create an inflationary danger.

Safeguarding Our Savings.

Less than half of the war outlays were financed from taxation. Rationing and price control, among other things, kept wartime

[1] In connection with this chapter the reader may wish to turn to Appendix D, "Inflation," in this book. This appendix is a reprint of my article appearing in *The Yale Review*, Summer, 1946.

spending in check. All these policies combined have given us our current large holdings of liquid assets. These assets still retain value, because thus far we have prevented inflationary increases in the price level. The control of inflation is in part the problem of protecting and safeguarding the war-accumulated savings of liquid assets.

In World War I the rising war incomes were in large measure dissipated in rapidly rising prices. At the end of the war, accumulations of savings were small by comparison with World War II. Nevertheless, too great reliance on automatic forces brought a further postwar inflation. The mere fact that savings accumulations were not large did not ensure price stability.

In this war, rising wartime incomes were in large part saved instead of being spent on a rising price level. But we are still confronted with the task of safeguarding these savings. They will vanish if we permit an extreme inflation.

I do not think anyone will deny that the prevention of any substantial wartime inflation in the United States, Canada, and England was a remarkable achievement. It was moreover unprecedented. It never happened before. Every earlier major war ushered in a price upheaval. Back in 1940 few believed it could be done.

In all earlier wars we have witnessed high interest rates and price inflation. This time we have witnessed low and declining interest rates with substantial price stability.

Why did these countries prove able to achieve during the war a high degree of price stability? Broadly speaking, the record is much the same in all three, but I shall limit myself mainly to the United States.

Effect of High Taxes.

First, looking back over it all, I believe that most fair-minded persons will agree that we did remarkably well in our wartime tax program. It was not perfect, and we could easily suggest improvements, but compromise is necessary in a democracy. I do not think anyone back in 1940 would have thought it possible to impose tax rates on corporate and individual incomes so high as were in fact imposed. (Consider also the very important reform —current collection at the source.) In the fiscal year 1944 we collected 44 billion dollars in federal taxes and in 1945, 46 billion

dollars. I think we must conclude that by and large Congress handled this extraordinarily difficult problem fairly well.

The French and German inflations following World War I are often referred to. Will the same thing not also happen here? Let me remind the reader that France financed not more than 13 per cent of her budget from taxes in any war year; Germany at no time more than 15 per cent. In the later war years we have financed about 45 per cent from taxes; Canada and England, about 50 per cent. Moreover, France obtained from abroad twice the amount raised from taxes, Germany in effect "printed money" equal to four times her tax revenues. In World War I, the highly conservative governments of France and Germany followed incredibly irresponsible fiscal policies. And they paid the price. In contrast, no one can say that wartime taxes in the United States were not severe. Our tax structure is an incontrovertible indication that we have followed, and mean to continue to follow, a responsible fiscal program.

The Public Savings.

Second, no explanation for the high degree of stability achieved in the greatest war in history would be at all complete without taking into account the remarkable steadiness and common sense of the public generally. Home owners, farmers, and consumers paid off their debts and saved substantial parts of their incomes. Not being able to buy many kinds of consumers' durables, they put their money into life insurance, savings and deposit accounts, and war-savings bonds. The record of stable mass psychology is all the more remarkable in view of the many alarmist articles which argued that policies currently pursued were cockeyed and nothing but chaos lay ahead. In the face of all this, businessmen and consumers displayed a sound common sense; and this psychological stability reflected itself in market stability. In this connection, the reassuring, factual material presented in the *Anti-inflation Bulletin,* prepared and distributed by the Institute of Life Insurance as a contribution of the life insurance companies in America to the price-stabilization program, deserves special mention. This bulletin went to news editors, editorial writers, and news commentators, and it played an important role in winning public approval and support. When cynics point to the

instability and weakness of democracies, the sound common sense and stability of the American public with respect to the management of their private finances during the war upheaval is reassuring; it affords solid ground for faith in the stability of our social structure.

Rationing and Price Control.

Third, we should not have come through had we not undertaken a thoroughgoing program of rationing and over-all price control. The doubting Thomases all said it could not be done; the American people, it was alleged, would not cooperate. But it worked. Perfection was indeed not achieved, and at times there were seriously disturbing black markets. But the over-all job is a creditable performance. Who would have believed back in 1941 that the women of the country and the retailers would have co operated as in fact they did in the intricate regulations involved in the point-rationing system? There were indeed dark days for the OPA, but those responsible for the program held the line with bulldog tenacity. The full story of this achievement has yet to be written.

Consumers' Goods Output.

Fourth, neither the OPA nor any other measure could have succeeded had it not been for the prodigious productive capacity of American agriculture and industry. While spending 90 billion dollars for war, we produced more consumers' goods than in any prewar year. Mass consumption of food was never so high, and retailers' shelves were never bare. Our productive potential proved to be far greater than any of us had dreamed possible.

Finally, the achieved record of wartime stability is related to the financial strength of the social order in America. This country has demonstrated, I repeat, enormous taxable capacity. Moreover, this country, at high employment levels, generates a vast stream of savings out of current income. A country with a vast capacity to save is not in great danger of inflation. This country has, moreover, at long last developed strong and secure savings and banking institutions. The Federal Deposit Insurance Corporation has become a bulwark of monetary and banking stability.

Mention should also be made of the Home Owners' Loan Corporation, the Federal Housing Administration, the Farm Credit Administration, and the Reconstruction Finance Corporation. The Securities Exchange Commission, the control of margin requirements by the Federal Reserve Board, the reforms instituted by the stock exchange itself, are now taken so much for granted that we are likely to underrate the stabilizing role they play.

Inflation alarmists often point to the record of immature and primitive countries. Such analogies are quite irrelevant. These countries had low taxable capacity, and accordingly the credit of the government was weak. Savings institutions were undeveloped and capital markets were lacking. Banking facilities were inadequate and shaky, and there was no powerful central bank to enter as a stabilizing factor in the money and capital markets.

It may safely be asserted without fear of contradiction that no government in all history, no private institution, ever enjoyed a higher credit rating than that now enjoyed by the governments of the United States, Canada, and England.

Savings Can Be Maintained.

But we are told that the war has made us too rich. We have accumulated, it is said, liquid assets so vast that we are incapable of holding on to them. Both as individuals and as business concerns we cannot, it is alleged, resist a vast spending spree. We haven't the capacity to conserve our savings. Is this true?

In economic matters it is highly important to view magnitudes in perspective. It is proper, indeed, to point to the high percentage increase in the liquid holdings (currency, deposits, and bonds) of individuals and corporations. But we must not forget that income has also gone up (and we do not mean to let it fall to the prewar level). It is significant that at high income levels, individuals and corporations save a high percentage out of current income. This fact implies a high capacity to hold savings already accumulated. Only at depression income levels are we likely to have any unloading en masse of our savings assets. And under those conditions we should all welcome dis-saving as a cushion against deflation.

No Capital Expenditure Spree.

Business concerns, indeed, hold around 80 billion dollars of cash and government securities. Will they therefore make inflationary capital outlays? Plant and equipment will no doubt be purchased on a substantial scale. But the days of overbuilding and the wildly speculative ventures of the late twenties are still remembered. Judicious capital outlays are now a reasonable expectation. May we not, however, witness a great scramble for inventories, such as that in 1919-1920? I should doubt it. Our transportation facilities are currently amazingly efficient. Deliveries can be made speedily. Inventory control has not been and should not be abandoned, indeed, it has recently been reinstated for certain commodities. We now have pretty accurate inventory statistics. Moreover, businessmen have not forgotten the consequences of the wildly speculative inventory spree in 1920. We are on safer grounds today.

Individual Holdings.

Individuals (including farmers) held in December, 1945, about 21 billion dollars of currency and around 22 billion dollars of demand deposits.[2] A part is needed for transaction purposes; a part is held as an idle asset. There are many reasons why individuals will want to continue to hold a large amount of cash as an asset. But suppose (as I do not expect) they should decide to unload a large proportion of their total cash asset holdings. The magnitude involved would be comparatively small as an offset to our annual gross savings. Nevertheless any such dis-saving would add to the inflationary picture.

As to mass holdings of savings bonds, the total volume of Series A-D and E bonds outstanding on Jan. 31, 1946, was 34.4 billion dollars. Some part of this was held by the well-to-do. Any inflationary development in consumers' markets must come from mass purchases; it does not spring from the spending of the rich. Will the war-savings bonds held by the masses be unloaded and spent? Yes, certainly to some extent; but as long as we are not faced with serious depression and unemployment, large new purchases of savings bonds will continue. Voluntary

[2] See *Federal Reserve Bulletin*, February, 1946.

pay-roll deduction for bond purchases is popular. It will decline sharply, of course, but it will not drop out. Some billions of bonds will be cashed in each year. But employed workers will continue to buy. The *total* outstanding *may* indeed decline in 1946 and 1947. But even this is by no means certain. There will certainly not be any mass liquidation of the whole 35 billion dollars. Should we run headlong into a serious depression, many will of course be forced to sell; but even in depression, many others confronted with impending insecurity will hold on very firmly and will indeed add to their holdings. Recent surveys indicate that these savings are firmly held. The holders of wartime savings, it is indicated, are not inclined to spend them recklessly.[3]

Business Holdings.

Of the 275-billion-dollar federal debt in January, 1946, around 175 billion dollars was held by banking, financial and savings institutions, government trust funds, and the Federal Reserve Banks. All of these holdings are insulated, so to speak, from the commodity markets.

It is said that corporations and other business concerns may sell their bonds to the banks in order to build plants and purchase new equipment. In view of the large cash holdings of business (about 44 billion dollars), this is not very probable on any large scale. Such sales as will occur will largely take the place of commercial loans.

Temporary Scarcities.

Consumers will indeed go into debt again to purchase automobiles and other consumers' durables. Many will hold their bonds and buy on credit. Consumer purchases, however, are made mainly out of current income. And income payments are now running at the wartime peak of 160 billion dollars per annum. Civilian unemployment (largely seasonal, frictional, and transitional) is down to nearly 2 million. Purchase of nondurables, closely related to income payments, has increased beyond expectations. Consumers' durables, however, if prices are kept in line, cannot reach a level much higher than, say, 15 or 16 billion dol-

[3] See *Federal Reserve Bulletin*, September, 1945; also *Fortune*, November, 1945.

lars per annum, if for no other reason than that the industries involved do not have unlimited capacity to supply a temporary high demand.

The temporary scarcities—housing and consumers' durables—create a special problem. This cannot be solved by "over-all" methods. Specific controls are needed until the temporary scarcities are overcome. They can be overcome only by rapid reconversion and increased production.

Over-all Demand.

Now, in spite of all I have said, there is no denying the fact that we *could* have an *over-all* demand in excess of supply, and so the general price level would sharply rise.[4] Nor can it be denied that the vast holdings of liquid assets *promote* spending. A society rich in liquid assets will *tend* to spend a larger proportion of its current income. It may also be more inclined to speculate, but that is by no means certain. If the urge to speculate, whatever the reason, is present, access to credit may supply the means just as effectively as liquid assets. We have seen that again and again.

Now in the event that an over-all excess of demand should develop, what is the remedy? A high rate of interest, as a remedy against inflation, is a weak reed to lean upon. A high rate of interest did not prevent a substantial price inflation in World War I. Cost of living rose from an index of 100 in July, 1914, to 162 in November, 1918. Wholesale prices rose from 100 in July, 1914, to 202 in November, 1918. After the war was over, high interest rates did not prevent a *postwar* inflation. Cost of living rose from 161 in February, 1919, to 208 in June, 1920; wholesale prices from 192 in February, 1919, to 248 in May, 1920.

No, if we are confronted with over-all inflation, we shall have to resort to tougher methods. The only adequate measures against over-all inflation are (1) to *tax* and (2) to *save*. We are not sufficiently sure what may develop. It is therefore sound common sense to go slow in reducing wartime tax rates. Secretary Vinson has rightly said that we must keep an eye on the dangers of both inflation and deflation. He suggested that a 5-billion-dollar relief

[4] For a comprehensive study of the whole inflation problem, see Seymour E. Harris, *Inflation and the American Economy*, McGraw-Hill Book Company, Inc., New York, 1945.

in taxes, on the best available evidence, was as far as it was wise to go. Congress, in fact, went farther than he advised with tax reduction. Confronted with an over-all inflationary tendency, we should be prepared to produce a budget surplus and reduce the public debt. A high rate of interest to lure people away from spending is a sugar-coated and very mild remedy. If aggregate demand is excessive, the effective remedy is to take away the excess money in *taxes,* curtail government expenditures, and reduce the public debt.

Compensatory Fiscal Policy.

It is amazing how many people, otherwise well informed, have not yet learned that compensatory fiscal policy is *not a one-way program.* Properly managed, it is always on the job, prepared to fight *inflation,* no less than *deflation.* Responsible management of compensatory fiscal policy means the control of expenditures, taxes, and borrowing so as to promote *stability.* To fight inflation, a budget surplus and debt reduction are in order. Fighting deflation and mass unemployment calls for reduction of taxes and increased public outlays on useful well-planned projects designed to improve both our human and our natural resources.

Equally, to fight over-all inflation during the "restocking boom," we should wage savings campaigns and continue as far as possible the pay-roll deduction plan. It is *mass* savings that are wanted if inflation is threatening. And for the sale of Series E bonds a high rate of interest would probably be no more effective than the current 2.9 per cent.[5]

Whether the rich and well-to-do hold bonds or cash is not very important as far as commodity inflation is concerned. From the standpoint of security or real-estate speculation, it might indeed

[5] I am unable to see that long-term marketable bonds are superior to savings bonds from the standpoint of inducing small investors to hold Marketable bonds are likely at times to fall in value, and this often causes heavy unloading. If a small investor knows that he can always get at least what he paid, he will not sell for fear of suffering a loss. Experience shows that savings bonds are the only kind that small investors will take and hold in any large volume. And security against loss of principal is surely more important than the rate of interest. It is to the credit of the Treasury that it has been bold enough to permit cash redemption at any time. This instills confidence and is doubtless an important factor in encouraging bond purchases.

be useful to tempt investors out of cash into bonds. But if the prospects for high speculative profits appear to be good, high interest rates would not deter many from going into the stock market or real estate. The high rate of interest during and after World War I did not prevent a violently speculative real-estate boom More direct methods are needed. Especially with respect to real-estate speculation we need, until we get over the hump, to institute additional controls.

Productive Capacity.

The President said in his Budget Message of Jan. 21, 1946, that our chief worry still is inflation. While pointing out that no backlog of demand can long exist in the face of our tremendous productive capacity, he nevertheless warned that even maximum production cannot remove the scarcities within a short time. The most serious deficiencies will persist in residential housing, building materials, and consumers' durables. Accordingly, he urged continued rent control, price control, control of consumer credit, priorities, allocations, and inventory control. "I am sure," said the President, "that the people of the United States are disturbed by the demands made by several business groups with regard to price and rent control." The President asked that the Price Control Act be renewed at once. The country had a right to know where the Congress stands. Any uncertainty would give rise to price speculation and to delays in achieving maximum production. The President also asked for an extension of the Second War Powers Act, which is the basis for priority and inventory controls. Following shortly the Budget Message, the President urged a far-reaching program to cope with the housing shortage.

Congress was slow to act on these recommendations. The new OPA Act passed in July, 1946, makes the task of price control difficult and precarious.

SUMMARY

In conclusion, the United States, with its vast capacity to save, its great taxable capacity, and its incredible power to produce goods of all kinds—agricultural products, lighter consumer goods, and heavy goods—is not from the *long-run* standpoint an "inflation-sensitive" country. Considering our vast capacity to produce, to-

gether with our high propensity to save, we are in far greater danger of inadequate markets than of a runaway inflation. Nevertheless, we need to be on our guard. We must not play with fire. We must be prepared to fight both general inflation as well as inflationary tendencies in specific areas. We must retain controls where needed until temporary shortages are overcome. We must retain a sufficiently high tax structure to guard against an excess over-all demand during the "restocking boom." We must have a program of wage and price stability. A stable wage policy means one that permits wage increases in accordance with productivity, but no more. If wages exceed the limits set by productivity, such wage increases are inflationary. Industries enjoying more than average increases in productivity should pass on the benefits to consumers in lower prices. A rational wage-and-price policy, consistent with the requirements of growth, expansion, and ever-rising living standards, is a *sine qua non* of economic stability.

Chapter II

Social and Economic Planning

SOME months ago I participated in a discussion on planning in the postwar world. Among the participants were some who expressed, in general abstract terms, vigorous opposition to planning in all forms. Theoretical arguments, drawn largely from Professor Hayek's book *The Road to Serfdom,* were expounded. There followed an address by a middle-of-the-road Republican senator, well known for his common-sense approach to practical problems, and utterly devoid of doctrinaire views. "I approach the topic," he said, "from the standpoint of the day-to-day problems that come before me as a member of Congress." Before he was through, he had touched upon many domestic and international problems upon which he was compelled, as a member of Congress, to have an opinion and about which something had to be done. For him it was not an abstract question about planning or not planning. For him some workable solution had to be found that might prove reasonably satisfactory, else up bobbed these questions again.

Atomistic Individualism.

The plain fact is that all advanced individual nations have moved very far away from the atomistic individualism of the mid-nineteenth century. Then economic opportunity meant essentially a chance to operate your own farm or small business. Today economic opportunity means largely a chance to get a job. Then the bulk of the population lived in the country—on farms or in small villages. Today they live in great urban centers. Industrialization and urbanization have come upon us with a speed that no one could have imagined in 1850. Torn from the old individualistic pattern of work and living into a society characterized by great factories and giant cities, modern man must erect a new social structure adapted to the changed conditions. In an in-

dustrialized and urbanized society, the individual cannot order his life alone. He can meet the problems of living only by joint action with his fellows. This is the great challenge of modern life —how to reconcile the rights and freedoms of the individual in a society in which group and community action is a necessary basis for successful living. This is the problem of democratic planning in the modern world.

Planning is, however, not something new. Its form and content have, it is true, changed. In the early days of our country, planning had to do, so far as economic matters were concerned, with creating an environment in which the citizens could successfully undertake to become small farmers, shopkeepers, or tradesmen. Essentially what was needed was a legal and economic environment favorable for the starting of a small enterprise. It became a primary responsibility of government to ensure the right to set yourself up in business. This right was not the product of automatic forces, as some naively suppose. This right was fought for in the great social and economic movements of the early nineteenth century. It was fought for in the antimonopoly movements, in the struggle for free banking, in the great Homestead movement which finally won the right to free land. The history of the first half of the nineteenth century was alive and glowing with great human programs—social plans to ensure and maintain economic opportunity.

The New Freedom.

A program to keep open the door for new enterprise remains also today a vital and necessary part of economic planning. Among other things, this means a revitalization of our antitrust laws and their enforcement, reform of our patent system, and an adequately financed Institute for Technical and Scientific Research to aid new and small business.

By and large the right to establish a business or to acquire free land was adequate, in the nineteenth century, to maintain economic opportunity and to ensure the right to "life, liberty, and the pursuit of happiness." This is no longer the case. In all modern countries the trend of technology, whether in industry, transportation, or distribution, restricts economic opportunity, for the overwhelming majority, to the getting of a job—not to

establishing a business of their own. If, therefore, we are to keep open the door of economic opportunity, under modern conditions, it becomes necessary for modern society to undertake as a primary responsibility the maintenance at all times of adequate employment opportunities. Just as the right to free land was the watchword of economic opportunity a hundred years ago, so the right to useful, remunerative, and regular employment is the symbol of economic opportunity today. The Murray Full Employment bill is today's counterpart of the Homestead Act of a century ago. The Homestead movement of the 1840's represented a great struggle for human rights and economic opportunity. It was fought by the forces of reaction. But the issue could not be evaded. So also with the full-employment program today. It involves elemental human rights—the right to life, liberty, and the pursuit of happiness. So long as 80 to 90 per cent of the population cannot earn a livelihood except by getting a job, the issue of full employment will not down.

The White Paper on Employment Policy, issued by the British Government in May, 1944, is the first formal acceptance by a leading nation of the primary aim and responsibility to maintain a high and stable level of employment. This was followed in April, 1945, by a similar declaration by the Canadian Government. In setting as its aim a high and stable level of employment, the Canadian Government specifically stated that it was not selecting a lower target than "full employment." Rather, it was mindful that it was breaking new ground and that it needed full public understanding and support to achieve its high goal. A mere declaration will not achieve full employment.

We shall indeed encounter innumerable difficulties in the pursuit of a full-employment goal. The fact that this experiment will prove difficult will not permit us to escape it. The problems that we shall be compelled to face will command the ingenuity and resourcefulness of both practical statesmen and theoretical economists in many decades to come. What I wish to stress here is my deep conviction that the political democracies of our time must undertake this new responsibility. We have reached a stage in economic evolution in which social planning must go beyond providing the economic opportunity to set up a business. For the

great majority of citizens, in the world in which we live, economic opportunity means the right to a job.

Free Enterprise and the Right to a Job.

The old right and the new one are interrelated. Freedom to choose among job opportunities in a free society presupposes the right and the opportunity for as many citizens as possible to establish a private enterprise. This right and this opportunity are important, not only for those who can and wish to become independent entrepreneurs, but also for those who remain employees This is true because only in a private-enterprise economy can the great mass of wage and salaried workers enjoy the essential freedom of choice of employment among thousands and thousands of different employers. In a totalitarian society there is only one employer—the state. It is a vitally important safeguard for the preservation of personal liberty that the citizens of a free society shall enjoy the opportunity to choose between numerous employers, including private entrepreneurs, cooperative societies, and governments, federal, state, and local.

Thus the great goal of full employment, if it is to be achieved in a free society, involves planning to make the market economy function in a workable manner so as to provide adequate employment opportunities together with the privilege of choice between different employers.

Democratic Planning.

If the democratic countries were not now planning and developing new institutional arrangements designed to make the market economy function more effectively than it did in the past, the future would be black indeed. Those who think that a reversion to the institutional arrangements of the nineteenth century would give us, in the world we live in, stability and prosperity are not realistic. They are nostalgic dreamers. They are fighting for a lost cause. We cannot meet the problems of today by institutions suitable to conditions that no longer exist. We need, and we are in fact devising, new plans both domestic and international.

The old market economy has broken down. It failed us utterly in the two decades between the two world wars. In England un-

employment, never falling below 10 per cent, reached in some years 22 per cent of the labor force and averaged 14 to 15 per cent for the entire two decades. In the United States, taking account of the whole interwar period, the spotty twenties and the depressed thirties, unemployment averaged about 12 per cent, and in the worst years, 1932-1933, reached 24 to 25 per cent of the labor force.

All hopes for the restoration of the old prewar economy were dashed in the great depression which shook the entire world and fanned the flames of the ensuing terrible world conflagration. International economic cooperation was completely cast aside. Economic warfare became the rule. The old order was destroyed. A new economic structure can be erected only on the basis of new institutions. We must rebuild the market economy, in both the domestic and the international spheres, so as to prevent similar disastrous breakdowns in the future. We are confronted with the task of devising new machinery, suitable to modern conditions, under which the market economy can operate effectively at high and stable levels of income and employment.

Total Outlay.

Under the market economy, good employment opportunities depend upon an adequate demand for goods and services. As the British White Paper on Employment Policy put it: "A country will not suffer from mass unemployment as long as the total demand for its goods and services is maintained at a high level." "Demand" in economic terminology does not mean "need" or "desire"; it means "outlay" or "expenditure." Adequate total *demand* means an adequate volume of expenditure whether by individuals, business, or government for goods and services.

Some critics have had a field day pointing out that high total outlay will not cure pockets of unemployment in stranded areas; nor will it cure seasonal, frictional, and technological unemployment. They have pointed out that expenditures on land, old houses, securities already outstanding, and the like do not create employment. They have moreover noted that increased outlays, if wages are increased more rapidly than productivity, would merely result in high prices without increasing employment.

These criticisms,[1] while accurate enough, are not very brilliant. They are old but important truths that we do well to remember. Neither the British nor Canadian Governments, nor the sponsors of the American full-employment proposals, are naïve enough to overlook these matters. The points raised have been discussed again and again, both in the theoretical and the applied literature. What needs *now* to be stressed is the all-important fact that the market economy cannot function even tolerably well unless the total outlay on goods and services, public and private, is maintained at a high and stable level. This is the central problem to which we must address ourselves if we really want the free-market economy to work. How can we ensure that the total outlay on goods and services will be adequate to provide continuing full employment?

The outlays on goods and services, as elaborated in nearly all current full-employment documents, can conveniently be divided into four categories: (1) private consumption expenditures, (2) private capital outlays, (3) current services of government, and

[1] Critics have also concentrated their attacks on the phrase "full employment." In this connection I should like to quote the following, which is a footnote taken from my pamphlet *After the War—Full Employment*, published by the National Resources Planning Board in February, 1943, long before the recent controversy developed. The footnote (p 3) is as follows:

"The term 'full employment' is often misunderstood and requires brief explanation. A little reflection will make it clear that in a highly dynamic society in which new industries are developing and some old ones are declining we must retain a high degree of labor mobility. In like manner, regional population shifts will occur in an expanding, developing economy In addition, in a democratic society with freedom of occupational choice, some considerable labor turnover is not only inevitable but, indeed, beneficial. Without this, personal freedom could not be maintained. Thus, a dynamic and mobile society requires some considerable shifting of jobs. Accordingly there will always be, in a society such as ours, a large amount of transitional unemployment. In addition, there will inevitably remain, even under the best planning by business and industry, a considerable amount of seasonal unemployment. For these reasons, in an economy as large as that of the United States, it is probable that at 'full employment' there would be at any one time between 2 to 3 million temporarily unemployed.

"It must, moreover, be recognized that the concept of full employment can acquire a definiteness only when it is conceived within the pattern of social customs and institutional arrangements which determine the size of the labor force and the customary hours of work. Thus, the labor force will be affected by the customary age of retirement and also by established practices with respect to minimum years of schooling and prevailing practices with

(4) government capital outlays on public works and developmental projects.

Private Consumption.

The first of these—private consumption expenditures—can be fairly closely estimated for different levels of employment. We know from all past experience that private consumer expenditures cannot be expected to reach a level adequate to employ the entire labor force. A rich society such as ours does not and will not spend all its income on consumers' goods. We need in the postwar period, it is estimated, a total outlay on goods and services of around 180 billion dollars [2] to provide full employment. But we know from long-established patterns of spending and saving (taking account of probable postwar taxation) approximately what the maximum contribution is that consumers can be expected to make toward that needed outlay of 180 billion dollars. The probable maximum is not far from 120 billion dollars. This means that around 60 billion dollars must be expended by private business on capital outlays and by federal, state,

respect to the age of entrance into industry. With respect to the hours of work, 'full employment' obviously does not mean that the population will work at the maximum possible hours that human endurance makes feasible. On the contrary, the prevailing hours of work will be determined by legislation, collective bargaining, and customary practices. The concept of 'full employment' presupposes that the normal labor force is working at the customary and prevailing work week.

"Finally, the concept of full employment relates only to those members of the community who are 'employable.' Unemployables, whether by reason of physical or mental defects, are not a part, properly speaking, of the labor force. The problem of what to do with these elements of our population is certainly an important one to which a democratic society must seriously address itself, but it is not part of the problem of achieving 'full employment.' It is, however, emphatically true that if we achieve a 'full employment' economy, the relative scarcity of labor thereby created will force our society to tackle more vigorously the problem of training and educating some portion of the 'so-called' unemployables, making them sufficiently efficient to be added to the employable labor force. This we have never done in the past because there has typically been available a reservoir of unemployed to draw upon. A full employment society, continuously maintained, will discover that it is quite possible through education and training to reduce very substantially the proportion of the population which has in the past been regarded as unemployable.

[2] If the price level rises substantially above that prevailing in 1943-1945, this figure would have to be adjusted accordingly.

and local governments on current services or construction projects. Only a drastic change in the expected peacetime tax structure or really fundamental changes in social security and income distribution could alter these figures substantially.

Private Investment.

Now while the maximum contribution to total outlay from consumer expenditures can be estimated with fair accuracy, we know very little about what may be expected from year to year in private capital outlays. In some years, private investment is high and in some low. It was 17 billion dollars in 1929, and it fell to only 2 billion dollars in 1932. Herein lies the essential explanation of the great depression. It is just this utter undependability of private capital outlays that makes the economic system so unstable.

Community Services.

The third category—public outlays on current services—can also be set down as a pretty definite figure. We know what the yearly outlays are on education, police protection, and the usual current government services. From the long-run standpoint we may wish to raise the figure gradually, but from the short-run it does not and should not fluctuate materially We know pretty accurately, therefore, what the contribution will be to total demand from this third category of outlay or expenditure.

Public Investment.

The fourth category—public capital outlays on public improvement and development projects—like the second, is subject to wide variation. Government construction projects for the most part do not have to be made in any one year. We can plan a 50-billion-dollar program, more or less, according to our prospective needs, over a 6- to 8-year period, and we can vary the annual outlays according to the requirements of stability and full employment. If private capital outlays decline, public capital outlays can be stepped up. Thus the public sector can act as a balance wheel to the private sector. With adequate planning, much could be done to stabilize the construction industry as a whole, taking account of both the public and the private sectors. Public projects

should be built in the usual case under private contract. Thus contractors would switch from private to public projects as private capital outlays declined and public outlays took up the slack. But the construction industry, privately owned and operated, would find a stabilized volume of outlays, public and private combined.

Social Security and Taxation.

Stabilization of the construction industry would go very far toward stabilizing the economy as a whole. But it cannot do the job alone. A broad and comprehensive system of social security and social welfare, combined with a progressive tax structure, acts steadily and continuously as a powerful stabilizing factor. It puts a floor under depression. It acts as a great irrigation system, distributing purchasing power widely over the entire country. Now that we have current collection at the source, cyclical variation in the standard income-tax rate can, I believe, serve as a useful and effective supplementary measure. Thus the three main measures upon which we must rely for stability and continuing full employment are (1) a comprehensive and flexible program of public improvement and developmental projects, (2) a comprehensive system of social security, and (3) variation in the basic income-tax rate.

Sustained Expansion and the Business Cycle.

Once these measures are adequately implemented to sustain and advance the level of income and employment, it will, I think, be discovered that the business cycle will become something very different from that experienced in the past. The cumulative features that have characterized the cycle for a hundred years would tend to disappear. Under the automatic forces that controlled the cycle in the past, once the downward movement got started, the cumulative process fed on itself. Unemployment spread fear among consumers and reduced the volume of expenditures. Falling prices and falling markets induced pessimism among businessmen and cut off new capital outlays. In contrast, a sustaining social-security and developmental program will tend to stop this cumulative process. Thus the cycle (within the framework of an adequate compensatory, developmental, social-security, and flexi-

ble tax program), shorn of its worst cumulative features, may become manageable and susceptible to social control.

The Need for Planning.

Modern governments are just at the threshold of this great experiment. We are still in the kindergarten stage. The stabilization of the construction industry alone involves an immense amount of physical and fiscal planning. It involves city planning and programs of urban redevelopment. It involves a comprehensive housing program, including not only a 20-year plan for the demolition of substandard houses, but also a long-range program of new residential construction, public and private. It involves a national plan for regional resource development in every part of the country, taking account not only of the great river basins such as the Tennessee Valley, the Columbia, the Missouri, and the Arkansas, but of land and water resources up and down the country that need reclamation, development, and conservation. It involves a thorough modernization of our entire transportation facilities—roadways, airways, waterways, and railways. In these three great fields—urban redevelopment and housing, regional resource development, and transportation—public investment must play an important role if we are to rebuild America on lines commensurate with the potentialities of modern science and modern technology. As we look at the deplorable physical condition of our great cities, the substandard housing both urban and rural, the congested urban transportation facilities, and the wastage of natural resources, it becomes abundantly evident that our greatest deficiencies are precisely in those areas that require large public investment outlays. We need to undertake a great national program of development. And such development would open up new rich fields for private investment.

I have underscored the role of a comprehensive system of social security and social welfare in a program of stability and expansion. Education, health and nutrition, recreational facilities, and community cultural activities are essential parts of a broad national development program. Of what good are mere brick and mortar if we neglect to develop a healthy, trained, educated, and socially minded citizenry? In our great country we are seriously deficient, not only in terms of natural-resource development, but

also in terms of human development. Forty per cent of our children grow up in areas deplorably deficient in educational facilities. A disquieting percentage of the young men drafted into the service were adjudged "functional illiterates" or were physically unfit for military duty. These are areas we must not neglect when we plan a well-balanced program of national development and public investment.

International Planning.

Planning for the future, however, cannot stop short at our national boundaries. National planning for stability and expansion involves not only domestic but also international plans. It is to the credit of the leading governments of our generation that we have not drifted on to the end of the war without a program. We are on our way to building a set of new international institutions that fit the needs of the world we live in. While the war was still being fought, we have held a whole series of international conferences—Atlantic City on Relief and Rehabilitation, Hot Springs on Food and Agriculture, Bretton Woods to devise a new international monetary system and to provide capital for international development, Dumbarton Oaks and San Francisco to give us a charter for a world government.

One of the main pillars of the United Nations Charter is the Social and Economic Council. Through this council the member nations will dedicate themselves to the continuing task of solving their common economic problems and of achieving international stability and expansion. This requires first and foremost full employment and economic stability within each country. Any country that fails at home cannot be a good neighbor in the family of nations. This is especially true of the great countries. There is nothing that the United States can do which will contribute more to international stability than to achieve a high and stable level of prosperity at home. Yet no country, at least none of the free countries that operate on the basis of a market economy, is immune to economic disturbance from the outside. Depression spreads, we have learned in the interwar years, with devastating effect from country to country. Collective action by the whole family of nations thus becomes necessary. The Social and Eco-

nomic Council can play an important role toward achieving a workable international order.

The agreements made by 44 countries at Bretton Woods, together with the inclusion of the Social and Economic Council in the San Francisco Charter, are indications that there is overwhelming agreement throughout the modern world that new international institutions are necessary if we would escape a repetition of the disastrous experiences between the two world wars. We are determined not to let things drift again. We mean to try to become masters of our fate. We shall not achieve a hundred-per-cent perfection. But we can nonetheless set our standards high. We have become convinced, at long last, that the old machinery will not work. We are no longer afraid to try something new. This is the meaning of the International Monetary Fund, the International Bank for Reconstruction and Development, the International Organization for Food and Agriculture, the Social and Economic Council of the United Nations Charter; and with respect to domestic policy, this is the meaning of such documents as the British White Paper on Employment Policy, the Canadian Paper on Employment and Income, and the Employment Act of 1946 in the United States.

The catalogue of programs, which I have just listed, is impressive. I have discussed the international aspects of this program of planning for the future in some detail in my recent book, *America's Role in the World Economy*. I cannot particularize here. The list of institutions that are there described and that are on the way to realization presents a strong contrast to the confusion and frustration that characterized economic policy all over the world 25 years ago. We have learned, I am convinced, a great deal from the terrible experiences of the last two decades. In all the advanced countries we are reaching some degree of agreement about what we need to do to reshape our world in order to make it again a functioning and manageable system.

The Free Societies.

In what I have said I have had in mind chiefly the problems confronting the free societies—the countries where economic life is ordered mainly on the basis of private enterprise, but with the

state playing nonetheless a large and increasing role. It has been aptly called a "mixed system." It is no longer the old simon-pure private-enterprise economy. But its most characteristic feature continues nevertheless to be *the market* or *the price system*. This basic characteristic is common to all the free societies—to the United States, Great Britain, the Scandinavian countries, Holland, Belgium, France, Canada, Australia, and New Zealand. It is upon these countries, in particular, that the task devolves to rebuild by means of new institutions, appropriate to modern conditions, a workable world.

Security and Progress.

Such a world must combine security with progress. There are those who have sought to show that these two goals are in conflict. But I think it can convincingly be shown that this is a highly superficial view. The modern urbanized world, highly interdependent geographically and occupationally, is extraordinarily sensitive to instability. The modern social structure cannot survive the kind of economic instability, domestic and international, we have suffered in our generation. Amidst such chaotic upheavals progress cannot flourish. And, conversely, it is not possible to achieve a high degree of stability except in an expanding world.

The restrictive policies of trade unions are most evident in the highly unstable building industry. Instability promotes restriction and contraction. Foreign trade restrictions—import quotas, exchange control, etc.—multiply in periods of deep depression and mass unemployment. Restrictive practices of all kinds are the instinctive defensive mechanisms of a contracting market. Expansion makes it possible to achieve stability without making it necessary to resort to the contrived and artificial stability of restrictive practices.

If we hope to win social and economic stability, we must make sure that productivity and standards of living are continually on the increase. Large-scale governmental support for scientific and technical research deserves to be put high on the agenda of public investment projects. The development of new products, new methods, new industries is an essential condition, not only of expansion and full employment, but also of economic stability

and social security. A stagnant society, incapable of raising the standards of living of its people, will not be a secure or stable society.

The "Road to Serfdom."

And now a final word about "planning" and the so-called "road to serfdom." There are those who allege, led by Professors Mises and Hayek, that conscious planning is not compatible with personal freedom. They would rely upon the automatic forces alone. Only such institutions as are basic to the necessary automatic processes are acceptable to them. All other planning is regarded as "bad planning." That, at least, is the logic of the case, and it is in fact the position of Mises. Hayek, a little less rigid and doctrinaire in his thinking than Mises, is forced to abandon logical consistency in the face of the hard realities of the modern world. Thus, he admits, somewhat reluctantly, the necessity of social security and some other measures involving a minimum of social planning.

The Rule of Law.

Hayek fears a world that requires human management. He has a great deal to say about the "rule of law." Yet he confuses automatism in social life with the rule of law. He forgets that the very concept of the rule of law was developed in England just at the time when there was a vast amount of governmental control of economic life. It was precisely because this was the case that the rule-of-law concept was developed. The rule of law does not mean that human management is replaced by automatic forces. It means that the conscious management of social life is conducted under established canons that preclude *arbitrary* action. The rule of law substitutes rational principles of management for the arbitrary acts of arbitrary men.

The widespread acceptance of social and economic planning by all modern governments is evidence that the hard experiences of recent decades have driven home the lesson that the functioning of modern economic life cannot be left to automatic forces. But it does not mean that we thereby deliver ourselves up to the arbitrary management of irresponsible men. That is not now, and never has been, the method of political democracy. The plans

we are devising, both domestic and international, are not ships let loose on an uncharted sea with instructions to the captains to steer as they see fit. Rational and democratic planning involves the development of rules of law that preclude arbitrary action by those who are chosen to administer the plans. This could be illustrated in any one of the plans, domestic or international, that I have reviewed. For example, while the International Monetary Fund does mean that we have abandoned the moorings of the old international gold standard, it will not leave us in international monetary matters adrift upon a sea of arbitrary decisions by the Governing Board of the Fund. New moorings to take the place of the old gold standard are established. Rules of law are set up which constitute a framework within which decisions are made.

In the decades that lie ahead, a major task of economic and social statesmanship must be undertaken precisely in this field. We must evolve rules of law under which the social planning of the future can be made a rational and democratic method of managing our social order. Only thus can we achieve the high goals of progress, stability, and full employment combined with the undying human values of personal and individual liberty. Without exception, all the great democracies are today embarked upon programs of social planning. In our own Anglo-Saxon tradition, the concept of social control *under law,* not control by irresponsible and arbitrary men, reaches far back into history. It antedates the age of modern capitalism. It reaches back into the early beginnings of local government. And it was never wholly lost sight of even in the heyday of *laissez faire.* We have a rich heritage of legal and political tradition which gives us high confidence and faith that we can achieve the great social and economic goals we seek without losing our personal freedoms.

PART TWO

SOME GENERAL CONCEPTS

Chapter III

National Income and Gross National Product

NATIONAL Economy," "Political Economy," and "Economics" have at different periods been used as descriptive titles for the subject matter discussed by economists. The term "National Economy" was used by early writers who were concerned with the economy of a nation, especially from the standpoint of the problems confronting the monarch with respect to the management of his domain. It was an extension to the nation as a whole of the concept of "household economy." The title used by Adam Smith in his great book *The Wealth of Nations* represents this tradition. He was dealing with the problems of the "national economy"; he was concerned with the magnitude and growth of the wealth and income of the nation as a whole. Already statistical estimates concerned with the national economy had been made, notably by Gregory King in his *Natural and Political Observations and Conclusions upon the State and Condition of England* in 1688.

Adam Smith was primarily interested in the "nature and causes" of the wealth of nations. He was eager to discover the "laws" that determined the level of output or real income—especially the role of division of labor. But he was also concerned with public policy and the effect of different systems of "political economy" on the "different progress of opulence in different nations." The term "political economy" was indeed used by Adam Smith as the title of one part of his book, and it became standard usage in the classical literature that followed.

A considerable part of neoclassical and modern "economics" devoted attention to the principles governing the production of separate industries and individual firms. But increasingly in recent years, economists have returned to the study of output and

employment as a whole. The central object of economic analysis is once again the "national economy" and the principles of "political economy" that govern the wealth and income of the nation as a whole.

National Income and Expenditure.

Of outstanding importance in the progress of economic science are the development and improvement in statistical studies of national income, consumption, saving, and capital formation. The path-breaking work of Dr. Simon Kuznets of the National Bureau of Economic Research has been supplemented by governmental research agencies, especially in the Department of Commerce, the Federal Reserve Board, and the Bureau of the Budget. Aided by frequent conferences on income studies, the concepts have been sharpened and the available materials enriched.

In England in the early war years, the Central Statistical Office, with the collaboration of the British Treasury, issued illuminating analyses of the sources of war finance together with estimates of the national income and expenditure. These state papers, presented by the Financial Secretary of the Treasury to Parliament, had a far-reaching influence on national-income studies throughout the world, and especially in the United States and Canada. The interchange of ideas has enormously enriched our knowledge in this area.

The "Net National Product" at market prices is the money value of the net product of *final* [1] goods and services produced in a given period. These are purchased by individuals, private business units, or by governments. The "Net National Product" plus capital depreciation equals the "Gross National Product."

[1] This refers to the "end products," the intermediate products being excluded. Thus the fuel and raw materials that are used up in the process of manufacturing clothes or radios, for example, are not counted. Only the final products are considered. The end products include the flow of output of consumers' goods and services together with new construction of houses, factories, business plant of all kinds, and machinery, which constitute *net additions* to the stock of capital goods.

This is the Net National Product, the *net* "end product." The Net National Product is arrived at after deduction has been made for depreciation and obsolescence of capital goods during the period under consideration. The Gross National Product concept, on the other hand, includes all capital goods produced during the period *prior* to deduction for wear and tear.

Gross National Product.

The following table shows the total outlays comprising the Gross National Product at 5-year intervals from 1909 to 1944, together with its component parts: (1) consumers' expenditures, (2) private gross capital formation, (3) government expenditures (federal, state, and local):

(In billions of dollars)

Year	Consumers' expenditures *A*	Private gross capital formation *B*	Government expenditures *C*	Gross National Product $(A + B + C)$
1909	25 5	6 0	2 5	34 0
1914	29 8	5 8	2 9	38 5
1919	51 3	17 2	8 6	77 1
1924	60 9	13 3	9 1	83 4
1929	70 8	17 6	11 0	99 4
1934	47 7	5 3	10 8	63 8
1939	61 7	10 9	16 0	88 6
1944	97 6	1 8	99 4	198 7

NOTE: Components may not add to total due to rounding

Aggregate Demand Sources.

The aggregate demand springs from (1) spending by consumers, (2) outlays by business or government from the current savings of individuals and business units, and (3) expenditures by government from tax revenues. The outlays from these three sources combined determine what will be the aggregate money value of the Gross National Product at market prices.

The reader will doubtless wonder why there are not four sources, the fourth being bank credit. Purchases may be made, by government for example, not merely from funds derived from taxation or from borrowing from the current savings of individuals and business units, but also by borrowing from banks. Such funds borrowed from the bank are *created* by the bank's crediting the government with a newly created deposit. Similarly, a business concern may spend not merely from current income or from borrowing from the public, but by borrowing freshly created credit from the bank. Should not, then, a fourth source be listed in the table, namely, bank credit?

No, not in a statistical table that registers what has happened during a past period, say a year. The reason for this is as follows: Let us suppose that the government borrowed 10 billion dollars from the banks. The banks credited the government on their books with 10 billion dollars of new deposits. The government drew out these funds by drawing checks against these deposit accounts. The checks were paid out to war contractors and other firms and individuals from whom the government had purchased goods or services, and these in turn distributed the money to wage earners, stockholders, etc. At the end of the year the public holds in its possession 10 billion dollars of new money either in the form of new currency (Federal Reserve notes) or additional deposits. Thus at the end of the year these new funds constitute added "savings" for the public as a whole. Whenever goods are purchased by funds borrowed from banks, the liquid savings of the public rise. Accordingly, in the statistical record, instead of listing a fourth item, "bank credit," as one source of expended funds, the term "savings" is made to include the net additional holdings of currency and deposits. Thus from this standpoint all outlays are made from (1) spendings, (2) savings, and (3) taxes. If the reader doesn't like the statistical definition of savings, he may exclude from "savings" the net addition to cash accumulations and add a fourth source from which outlays are made, namely "new money."

If, however, we adopt the statistical (ex post) concept of saving, then the total flow of money payments made for all the final goods and services produced springs from the following sources:

1. Spending (by consumers)
2. Saving (by individuals and business units)
3. Paying taxes (by individuals and business units)

These three categories indicate the manner in which the funds paid out by consumers, business, or government are made available. A part of the funds enters the market place via the taxation route, a part via the savings route, and a part via direct consumer spending.

The Gross National Product may therefore be divided into these categories: (1) consumption expenditures, (2) gross[2] sav-

[2] Gross saving includes charges to depreciation and other reserves.

ing, (3) taxes. As an illustrative model the following table in round numbers is offered:

(In billions of dollars)

Consumer spending		120
Gross [2] saving		30
Business	15	
Personal	15	
Taxes		30
Business	15	
Personal	15	
Gross National Product		180[3]

Savings and Investment.

In the event that the entire flow of current business and personal savings finds an outlet into private capital formation (houses and other construction, machinery and business equipment, etc), current saving would equal private investment, and government outlays would be matched by taxes. Under these circumstances the component parts of the Gross National Product could be set down as consisting of (1) private consumption, (2) private capital formation, (3) tax-financed goods and services. But such a balance between saving and private investment on the one side, with taxes equaling government outlays on the other side, would rarely be achieved. Looking back over the statistical record (ex post), if the government budget was overbalanced (*i.e.*, tax revenues exceed government outlays), private investment would exceed saving. If the government budget was unbalanced (*i.e.*, outlays exceed taxes), then saving would exceed private investment. Ex post, saving plus taxes must equal private investment plus government outlays. In other words, the statistical record will always disclose that "gross saving" [4] must equal private investment plus government-loan expenditures; while taxes necessarily

[2] Gross saving includes charges to depreciation and other reserves.

[3] This illustrative model is based on the 1943-45 price level.

[4] Let gross saving be S', and private gross capital formation + government loan expenditures be I'. Then, ex post, $S' = I'$. But this only gives us the statistical data *after the event.*

Consider the matter in terms of the Robertsonian period analysis. Let S = Robertsonian saving, and N = new money (ΔM) and the injection of idle money (ΔV) into the spending stream. Then $S' = (S + N) = I'$. Accordingly, if income is rising from day to day $I' > S$ (*i.e.*, private gross capital formation plus government loan expenditures will exceed Robertsonian savings—saving from "disposable" income—by the amount of new money created from banking loans to business or to government or by loans to business or

equal tax-financed government outlays. The following table is presented by way of illustration.

(In billions of dollars)

Sources		Outlays	
Consumer spending	120	Private consumption outlays	120
Gross saving [4]	30	Outlets for saving:	
		(1) Private gross capital formation	20
		(2) Government loan expenditures	10
Taxes	30	Tax-financed expenditures	30
Gross National Product	180	Gross National Product	180

Various Concepts of Product and Income.

For the reader who is puzzled about the interrelation of Net National Product, Net National Income, Income Payments, and the component parts of Gross National Product as given in the preceding table, the following illustrative model, using the same round numbers as above, may perhaps be helpful. Complicating details are omitted in order to fix attention upon the essential elements. We begin with the Gross National Product and then make a series of deductions until at last we arrive at Consumer Expenditures.[5]

government from hoarders of idle cash. In Fisherian language, the income (MV) of tomorrow exceeds the income (MV) of yesterday by N (*i.e.,* by an increase in M or an increase in V)

In a dynamic society (with improving techniques and a growing labor force) money income must rise if full employment is maintained at a stable price level; or in Robertsonian language, investment will exceed saving. "Investment" here includes all offsets to savings—public loan expenditures as well as private investment. In Robertsonian language, saving and investment are in equilibrium only when money income flows on at a constant level. If income rises, investment exceeds saving; if it falls, saving exceeds investment. However, in the statistical sense (ex post) saving and investment are always equal. (Saving and Investment are also equal in the "logical" or "mathematical" formulation of Keynes.) In other words, saving from the "disposable" income of "yesterday" (Robertsonian "saving") must, if money income rises, be less than the realized saving springing from the higher income of "today" (saving in the statistical or ex post sense). See my article "Fiscal Policy: A Clarification," *American Economic Review,* June, 1945.

[5] *Transfer payments* (relief and public-assistance disbursements, soldiers' bonus and pensions, and benefit payments from social-security funds) and contributions to the social-security funds (pay-roll taxes) are omitted for sim-

(In billions of dollars)

Gross National Product	180
Deduct, depreciation, etc. (replacement savings)	10
Net National Product	170
Deduct, business taxes	15
Net National Income	155
Deduct, corporate savings	5
Income payments to individuals	150
Deduct, personal taxes	15
Disposable income of individuals	135
Deduct, net savings of individuals	15
Consumer expenditures	120

The Net National Product ("net" after depreciation and obsolescence) includes the money value at market prices of all goods and services privately purchased plus the money value at market prices of all publicly purchased goods and services. A large part of the goods and services sell at market prices that include sales taxes and other indirect taxes. The money value of these goods and services at market prices thus exceeds the factor costs, *i.e.*, the money paid out to the factors of production, including rent of land and buildings, profits and interest, wages and salaries, which together constitute the Net National Income.

In a society that had no indirect taxes, Net National Income (factor costs) would equal Net National Product.[6] This equality would come about either through a rise in the income of the factors of production until Net National Income equaled the

plicity since they more or less balance out. In some past years the contributions to these funds have exceeded transfer payments, and this difference should then be added to total savings; if the contributions are less than transfer payments, the difference becomes dis-saving. For some years to come transfer payments are likely to exceed pay-roll taxes.

[6] This statement is made on the assumption that corporate *income* taxes are included in Net National Income, being regarded as in fact part of the income taxes paid by stockholders. All corporate net income (prior to income taxes) is from this point of view considered to be a part stockholders' income, and therefore a part of Net National Income or factor costs. This is in line with British statistical practice. In the United States, we have excluded corporate income taxes from Net National Income. It is rumored that American practice, in this respect, may be changed There is no doubt in my mind that net corporate income *prior* to income taxes should be included in Net National Income.

THE FEDERAL BUDGET AND THE NATION'S BUDGET

Calendar years 1939 and 1944 (current prices * in billions of dollars)

Economic group	Calendar year 1939			Calendar year 1944		
	Receipts	Expenditures	Excess (+) Deficit (−)	Receipts	Expenditures	Excess (+) Deficit (−)
Consumers:						
Income after taxes	67 3			134 5		
Expenditures .		61 7			97 6	
Savings (+)			+5.6			+36 9
Business:						
Undistributed profits and reserves	8 3			10.6		
Gross Capital formation		10 9			1 8	
Excess of receipts (+) or capital formation (−)			−2.6			+ 8 8
State and local governments:						
Receipts from the public other than borrowing	8.9			10 1		
Payments to the public		9.1			8.3	
Excess of receipts (−) or payments (−)			−0 2			+ 1 8
Federal government:						
Receipts from the public other than borrowing	6.5			48 1		
Payments to the public		9 3			95.6	
Excess of receipts (+) or payments (−)			−2.8			−47.5
Less:						
Adjustments † . . .	2.4	2 4		4 6	5.6	
Total: Gross National Product.						
Receipts	88 6			198 7		
Expenditures		88.6			198 7	
Balance			0			0

* Prices in 1944 were between 25 and 30 per cent above 1939.
† Mainly government expenditures for other than goods and services.

Net National Product at the old level of market prices, or else through a fall in market prices (as indirect taxes were removed) until Net National Product at market prices equaled the old level of factor costs (*i.e.*, Net National Income).

The Nation's Budget.

An illuminating analysis of the relation of the budgets of the federal government and of the state and local governments to the nation's budget as a whole, including the budgets of consumers and of business, was made in President Roosevelt's last Budget Message. It is reproduced on p. 38. It will be noted that in 1944, for example, the excess savings (over and above gross capital formation) of consumers, business, and state and local governments balanced the loan expenditures (deficit) of the federal governments. This illustrates, from the data for this calendar year, that gross savings (ex post) must equal gross private investment plus government-loan expenditures. In general the table discloses the savings-investment problem in a revealing and significant manner.

Historical Record of Spending and Saving.

The historical record of consumer spending, saving, and tax payments (federal, state, and local) is shown in the table below by 5-year intervals from 1929 to 1944.

This table may be compared with those on pages 35 and 36 above. If government expenditures exceed taxes, the difference is financed from saving as here defined.

(In billions of dollars)

Year	Consumer spending *A*	Gross saving *B*	Taxes *C*	Gross National Product * (*A* + *B* + *C*)
1929	70 8	18.6	10 0	99.4
1934	47.7	6.7	9.4	63.8
1939	61.7	13.3	13.5	88.6
1944	97.6	52.7	48.6	198.7

* Components may not add to totals due to rounding and adjustment for discrepancies between the *outlay* estimates and the *disposal* estimates.

The volume of gross saving is mainly a function of the level of income and of taxes. If the income is high, as in 1929, the gross saving will be high; if low, as in 1934, gross saving will be low. To achieve full employment it is necessary that private gross capital formation and government-loan expenditures together shall be high enough to absorb the gross savings generated at high employment levels. Private gross capital formation is a highly variable item. But government-loan expenditures are subject to conscious social control. If the latter is planned to offset fluctuations in the former, the two together could be held at a stable high level. The level should be sufficiently high so that, together with the maximum contribution which consumers are willing to make plus the tax-financed outlays of government, the total will add up to an adequate aggregate demand for goods and services. Given the volume of tax-financed expenditure and the willingness of consumers to spend (consumption function), the level of aggregate demand is determined by the combined volume of Private Gross Capital Formation and Government Loan Expenditures.

Chapter IV

Aggregate Demand

IN A market economy production and employment rise and fall as a result of changes in the volume of purchases of goods and services. In a totalitarian society it is possible for the central authority to allocate workers directly to jobs in different industries. But this is not possible in a society that operates under market forces and the price system.

In the United States, Canada, Great Britain, Australia, New Zealand, the Scandinavian countries, Holland, Belgium, and France—that part of the western world that comprises the bulk of world trade—private enterprise produces the overwhelming part of goods and services. Yet the state is playing an increasing role. In none of these countries is the system simon-pure private capitalism; nor is it thoroughgoing socialism. It is a "mixed" system, in varying degree. Everywhere there is opportunity to work for hundreds and thousands of employers. There is nowhere in these free societies one single employer—the state. In all the western political democracies jobs are available both in private enterprise and in the government service. This ensures a freedom of choice of employment that is not possible in a totalitarian order.

The Role of Aggregate Demand in Free Societies.

The important place of private enterprise is deeply felt and recognized even in the labor and socialist countries of western and northern Europe. Steeped in the tradition of personal liberty, there is no indication that they are going totalitarian. Planning and social control are indeed on the increase, and so also is public ownership. But private enterprise will continue to function and to be guided by demand factors. Consumers' choices register in the market place and determine (given the level of technique) the distribution of jobs of different kinds. And adequate aggregate

demand, not regimented direction, is the basic determinant of the aggregate number of job opportunities. Thus in the "mixed economy" of modern political democracies, full employment must be achieved, not by the simple process of setting people directly to work, but by the far more complex process of ensuring an adequate volume of aggregate demand.

To create any given volume of expenditures, public and private, is really no very difficult matter. What is difficult is so to manage the economy that the needed aggregate volume of demand will yield full and sustained employment and ever-rising living standards. What is difficult is to carry through with a sustained, balanced, and efficient program. We could easily mismanage the job. It is not enough merely to supply the motive power. We must also hold the economic car in the middle of the road. Aggregate spending is no cure-all. It is merely the first prerequisite, in a market economy, for full employment. Adequate total demand is for the national economy like an adequate diet for an individual. But a well-fed person may be afflicted with diseases of different kinds. The same is true of the national economy. Though aggregate demand is adequate, a country may yet suffer from monopolistic restrictions, from strikes, from unbalanced wage-and-price structures, and from unemployment in stranded areas. All this is true, but it must nevertheless not be forgotten that aggregate effective demand is the *sine qua non* of full employment in a market economy.

Total Outlay.

Adequate demand springs from outlays on goods and services. These outlays, as we have noted in Chaps. II and III, can be conveniently divided into four categories: (1) private consumption expenditures, (2) private outlays for capital formation (residential and business construction, machinery and business equipment, inventories, net foreign investment), (3) current services of government, and (4) governmental capital outlays on public works and developmental projects.

The first of these—private consumption expenditures—is by far the largest constituent part of aggregate demand. But economic arguments are often built on the erroneous assumption that private consumer outlays in modern society can reach the

level of adequate aggregate demand. This is far from the case. We know from all past experience that private consumer expenditures in advanced countries have never been adequate, or nearly adequate, to provide full employment. For example, in such full-employment years as 1923 and 1929, private consumption constituted only 71.2 per cent of the Gross National Product.

Consumption.

The absolute volume of consumer purchases rises and falls with employment and aggregate output. But the fluctuation of private consumption with aggregate output is not *proportional* to changes in output. At low employment (low output) levels, aggregate consumption falls off, but consumption as a *per cent* of Gross National Product increases. As output (real income) falls, the bare essentials constitute an increasing proportion of total outlays. During deep depressions, advanced industrial societies are pushed back to low living standards. Luxuries and high-standard products are dispensed with, as output declines. The *absolute* volume of consumption falls off; but the reduced volume of output is more and more concentrated on necessities. Durable goods of all kinds go unpurchased (and therefore are not produced in volume). The demand for capital goods in particular declines. Thus output declines more rapidly than private consumption; and within the consumption category, luxuries and consumer durables (automobiles, refrigerators, etc.) fall more rapidly than consumption as a whole. Thus as depression deepens, the society is reduced more and more to the bare essentials of consumption. Depression and unemployment drive advanced societies toward the consumption standards of primitive and undeveloped societies.

Public Services.

Also from the long-run secular standpoint (apart from the short-run movements of the cycle), *private* consumption has failed to keep pace (proportionally) with increasing output. And this is no accident. Along with higher productivity and higher living standards there has come, in all advanced countries, a growing volume (both absolutely and relatively) of community services.

In every highly industrialized society these constitute an important and indeed necessary part of an adequate aggregate demand.

This proposition may at first appear startling. The explanation involves an analysis of the manner in which a society achieves a high standard of living. This is a gradual process. As productivity increases, it is not enough merely to consume more of the old and familiar goods and services. In primitive societies the vast bulk of the resources were devoted to the production of food. As societies evolved more productive techniques, they also devised new types of consumption. Without the invention of *new* products and new *kinds* of services, the improvement in technique (permitting larger and larger per capita productivity) would merely have caused ever-increasing unemployment, instead of an ever-rising standard of living. *Variety,* and still more variety, in consumption is the necessary condition for the maintenance of adequate demand in an ever more productive society. And the invention of *new* products does not necessarily coincide with the advance in productivity. The invention of the automobile was a fortunate accident at a time when the *processes* of production were rapidly changing, resulting in a great increase in man-hour productivity.

Let us suppose that the automobile, by some magic wand, vanished completely as a product of modern industry. If this happened, we might of course use the purchasing power thus set free to buy *more* of other things. This *in part* would indeed occur. The satisfaction of other wants would be pushed further toward satiety. But this is not all. The "propensity to consume" [1] would

[1] "Propensity to consume" is a technical phrase which describes the more or less stable relation that exists in any given society between total consumption and national income *at different levels of national income.* The propensity to consume can be stated in terms of a table showing the amount of national income that is spent on consumption at different levels of national income ranging from a full-employment national income to the depressed level of national income when there is large mass unemployment.

Sometimes the phrase is also used to describe the relation between consumption and *family* income at different levels of family income.

Economists have not infrequently contributed to confusion by using the same phrase to describe both of these concepts. To avoid this it might be desirable to call the former the "National Consumption Function" and the latter the "Family Consumption Function."

For a discussion of the consumption function see Alvin H. Hansen, *Fiscal Policy and Business Cycles,* Chap. XI.

fall: smaller expenditures (at any given income level) would be made for private consumption. Aggregate demand would fall.

As productivity has increased in all modern nations, one of the areas of diversified consumption that has been developed is that of free services of different kinds supplied by the community as a whole. An ever-increasing part of our standard of living consists of community consumption as distinguished from private consumption. An increasing part of the productive resources of advanced industrial nations is devoted to the production of community services. This is the explanation of ever-growing governmental budgets. If we followed the advice of so-called "sound finance" and sharply curtailed government-service outlays, the propensity to consume for the community as a whole (public and private) would decline, and aggregate demand would fall. No modern country could have achieved its varied and rich standard of living without this historical expansion in the area of social and public services.

New Frontiers of Consumption.

During the war we have suddenly discovered the vast productive potential which we had been developing gradually during the preceding decade. Our productive capacity is now 75 per cent or more above that of 1929. With this vast increase in productivity we cannot hope to achieve full employment without a revolutionary advance in our standard of living. Such an advance is not easily reached. In part it is indeed a matter of consuming more of the old types of goods and services. In part it is a matter of pushing into new frontiers of consumption, both public and private. Without a large expansion of social and public services we are not likely to succeed in raising our standard of living to a level commensurate with our productive power. This means a large increase in education, public-health facilities, social-security benefits, social-welfare outlays, and public housing for low-income groups.

These are the things most urgently needed to raise our living standards. They cannot be achieved without large public outlays. But it is not merely a matter of using our production resources for those things that yield the highest social utility. It is in large part a matter of the *degree* to which our resources are employed.

If these public services were not provided, the area for consumer outlay would be greatly restricted as to both scope and variety; the propensity to consume would fall. Aggregate demand would be inadequate to provide full employment.

The area of private consumption itself would be very much smaller than it is were it not for the great expansion that has occurred in publicly provided services. Consider the matter of public education. The vast private industry of printing and publishing is dependent upon the free schools. And this area has possibilities of really prodigious expansion. With millions of functional illiterates in this country, with nearly half our children growing up in areas having seriously substandard educational facilities, with inadequate facilities for adult education, it is no wonder that the proportion of Americans who read books is small. Education is doubtless the most impressive illustration; nevertheless, in general, without public outlays for social and community services, the high standard of living and consumption that is necessary to ensure adequate aggregate demand could not be reached in any advanced industrial nation. Thus a large government budget in modern communities is a *sine qua non* of full employment.

Consumption and the Price System.

This is all the more true because private consumption expenditures in all industrialized societies fall below what they might be (and thus aggregate demand is likely to prove inadequate), owing to conditions arising in part from the *normal* functioning of the price system and in part from the *malfunctioning* of the system. The normal functioning of the price system inevitably produces an almost incredible inequality in the distribution of income.

This arises of necessity for two reasons: First, the inequality of native capacities produces an unequal marginal value product among different individuals. Consider, for example, the opera singer or the movie actor. Despite the fact that the "woods are full" of good musicians and actors, only the services of the superbly excellent are in high demand. The same holds true in a measure for all occupations. In the second place, the institutions of private property and inheritance of private property operate to create inequality in income, partly by intensifying inequality of opportunity (and so inequality in the distribution of income

earned from physical or intellectual labor) and partly by concentrating income in the hands of the relatively small part of the population who own the bulk of the wealth.

Greater equality in the distribution of "earned" income can be attained by providing, as far as possible, equality of opportunity. Equality of opportunity means better education for all the children of the nation, regardless of the region in which they may happen to be born, adequate high-school, college, and university scholarships for gifted children, better nutrition and more adequate provision for health facilities, and medical care for the entire population. Greater equality in property income can be attained by a steeper progression and lower exemptions in inheritance taxes, and by a wide distribution in the holdings of government bonds, savings accounts, life insurance, and by widespread home ownership. Greater equality in income distribution can moreover be reached through progressive income taxation, combined with social-security and social-welfare measures.

Inequality in the distribution of income tends to lower the schedule of private-consumption expenditures—the "consumption function"—because the income flows disproportionately to those whose wants are amply provided for, and who therefore spend only a portion of their income on consumer goods and services. To the extent that more of the national income flows to the lower income families (those spending a high proportion of their income), the total outlays on private consumption will rise.

Greater Equality Has Limited Effect.

This analysis, while correct, is often exaggerated. It is sometimes said that since families in the $1,500 disposable-income (*i.e.*, income after taxes) group spend fully 100 per cent of their incomes while those in the $100,000 disposable-income group spend on the average, say, 30 per cent, a redistribution of income from the latter group to the former will raise the consumption-expenditure ratio of an increment of income so redistributed from 30 per cent to 100 per cent. But this is not true. It is the *marginal* propensity to consume (not the *average*) that is determining. In other words, the relevant question is, What proportion of the *last increment* of income is consumed at each income level? While the *average* propensity to consume is 100 per cent for the lower

income family, the *marginal* may be only, say, 70 per cent.[2] Similarly, the *average* propensity to consume for the rich may be 30 per cent, while the marginal is, say, 25. Thus the transfer of an *increment* of income from the higher to the lower income group will mean an increase in consumer outlays from 25 per cent of the given increment to 70 per cent, and not from 30 per cent to 100 per cent. While this qualification is important, it is nevertheless true that greater equality in income distribution would raise the schedule of consumer expenditures in relation to income.

Supplements to low incomes (such as family allowances) would tend to raise the level of private consumption expenditures. An increase in minimum wage rates in low-wage industries is an important measure, especially in the United States, where the wage differential between industries is enormous. In some cases the higher wages can well be paid out of profits (for example, bank clerks are seriously underpaid, while bank earnings are large). In other cases (textiles may be a good illustration) higher wages may involve some increase in the price of the product. This would amount in general to a redistribution of income from higher income groups to the low-paid workers, and such transfer would increase total private consumption expenditures (*i.e.,* raise the "consumption function").

High-wage, Low-profit Economy.

"A high-consumption economy, *i.e.,* an economy with a high level of income but no excessive saving, should be a high-wage, low-profit economy."[3] This is the goal that modern industrial communities need to reach in order to ensure adequate aggregate demand. There are to be sure obvious limits to this process. Private enterprise cannot function unless costs (including imputed interest on invested capital) are adequately covered, leaving a reasonable margin of profit for security, survival, and growth.

A highly fluctuating society is confronted with a wage-profit dilemma. The losses in depression years must be offset by high profits in good years, or the industry cannot survive. Yet the high

[2] In other words, any *additional* increment of income may be used 70 per cent for consumption and 30 per cent for payment of debt or savings.

[3] John H. Williams, in *Financing American Prosperity,* Twentieth Century Fund, 1945, p. 369.

profits of high-income years restrict the level of consumption expenditures. After some years of high investment (in excess of the normal rate of growth) profitable investment outlets for the high volume of profits (whether retained by the corporation or saved by dividend recipients) can no longer be found. Thus the high-profit economy of boom years inevitably drives headlong into a depression. The level of private consumption expenditures is not high enough to sustain continuing high employment.

Thus a serious dilemma presents itself. The modern economy operates in a vicious circle. Depression losses must be balanced by prosperity profits. But prosperity profits are not compatible with the high-consumption (high-wage, low-profit) economy needed to sustain full employment unless indeed vigorous countercyclical action, on a scale difficult of realization, is taken by the government.

From the long-run standpoint, a persistently pursued policy to maintain full employment raises interesting questions with respect to the effect of such a policy on (1) the distribution of income, and (2) the proportion of a full-employment income which it may be expected would be expended on consumption. In brief, it is reasonable to suppose that the ratio of consumption to income in a full-employment economy would automatically tend to be higher than the ratio of consumption to income at the peak of a boom in a violently fluctuating economy. A full-employment economy would tend automatically toward a distribution of income favorable to high consumption. This affords ground for optimism with respect to the feasibility of a positive program designed to maintain full employment.

In a society operating at continuously full employment, it is not probable that peak-prosperity profits (in 1925-1929 nearly twice the average for the entire period 1925-1940) could be maintained indefinitely. In a fluctuating society such high profits are necessary to offset the losses of the depression years, but it is unreasonable to suppose that profits of the magnitude of boom periods would be realized indefinitely in a full-employment system. They would almost certainly be eaten into, partly by competitive price decreases benefiting consumers and partly by the pressure for higher wages which invariably occurs in industries making large profits. Either development would tend toward a

more equal distribution of income than has prevailed in the past *in boom periods* when full employment was reached. This is true because of the relative decline in the ratio of business profits to the national income *at full-employment levels.* Yet, if a full-employment income were continuously maintained, the *magnitude* of business profits *could* be considerably greater (even though the average ratio of profit to income were no higher), since the average national income for the whole period would be very much higher if we succeeded in achieving substantially full employment.

It must be recognized, however, that there are certain limitations on how far profits can be encroached upon, through either wage increases or price decreases, without encountering unfavorable economic repercussions with respect to the cost-price structure. Wage increases and price reduction are likely to cut across all firms in an industry, whether they make profits or not; and wage increases are likely to spread even to industries that are not making abnormally large profits. Thus, the process of encroachment upon boom-time profits through wage increases and price reduction, if carried too far, may disrupt the appropriate balance in the cost-price system.

Redistribution of income through progressive individual and corporate income taxes is less disruptive of these relations for the reason that such taxes apply only where the profits and income actually emerge. They do not affect the high-cost industries that make no profit. As already indicated, there are limitations upon the process of redistribution of income through the methods of wage increases and price reduction. These methods are feasible up to a certain point, but the point is fixed by the requirements of cost-price balance.

Consumption can, nevertheless, be very materially raised through wage and price adjustments in a society continuously maintaining full employment. There would still remain, by reason of continuous capacity output, adequate profits to sustain and motivate private enterprise—indeed, better absolute profits over the long run than those experienced on the average in a highly fluctuating society.

Such a shift evolving gradually could add several billions of dollars per annum to consumption expenditures at full-employ-

ment levels. In addition, continuing improvement in labor productivity as a result of technical progress would make possible progressive wage increases without encroaching on the necessary profits required to motivate a private-enterprise economy.

Capital Formation and the Normal Rate of Growth.

Private consumption expenditures have always in high-employment years been too low relative to the volume of private capital outlays. Prosperity, under the automatic functioning of the economy, has always in the past been achieved on a basis that in the nature of the case could not be sustained—namely, by a volume of capital outlays far exceeding the normal rate of growth.

In the 20-year period, 1921-1940, the ratio of private capital formation to Gross National Product averaged about 13 per cent. This figure may tentatively be assumed to represent a ratio of private-capital outlays to Gross National Product that could be maintained year in and year out without causing a disequilibrium between the productive facilities (the stock of producers' capital) and aggregate demand. The ratio of capital formation in the boom twenties (16 per cent of Gross National Product) exceeded this normal rate of growth. The growth in capital formation obviously stands in some relation to (1) changes in technique (increases in per capita productivity) and (2) increases in the labor force. The volume of new private-production facilities that can profitably be added to the existing stock, year in and year out, is related to the rate of technical innovations and the rate of population growth. Beyond a certain amount, production facilities (capital goods) would become so excessive as to reduce the yield on an additional increment to an unprofitable level. We could not continue to build office buildings, hotels, houses, and factories, or to install machinery *at the rate* we did in the decade of the twenties without bankrupting the owners of existing properties. Always the spurt of capital formation in boom years exceeds the normal rate of growth.

The normal rate of growth of private capital formation could be raised by adequate provision for research on new products and new technological processes. It could also be raised by an expansion of basic public investment on regional and urban develop-

ment—projects that would open up new fields for private investment.

In order to achieve an appropriate balance of private consumption expenditures to Gross National Product, at a sustained high level of employment, it would be desirable to stabilize private capital outlays at approximately the normal rate of growth. This is no easy matter. The war has created a serious shortage in housing which must be made up at the first possible moment. There are accumulated shortages in commercial structures, arrears in up-to-date machinery, etc. These "deferred demands" for capital goods of different kinds will inevitably create "bulges" in capital formation. And this, in turn, through the "replacement waves" that will follow, will lay up difficulties for the future. Moreover, technological innovations have never, in past industrial history, found embodiment in capital facilities at a smooth, uniform rate of growth. New capital formation, springing from changes in technique, has come in spurts. This is partly due to jerkiness in the evolution of technology, and perhaps still more to the response of entrepreneurs to innovation—the herdlike movements so vividly described by Professor Schumpeter. For all these reasons it will be no easy matter to stabilize, at the normal rate of growth, the volume of private-capital outlays.

The Role of Public Outlays.

Thus it will be necessary, at least in the foreseeable future, to offset as far as possible unavoidable fluctuations in the rate of private investment outlays. This means, in effect (1) an increase in public outlays, partly on public construction, partly for public subsidies [4] to increase private consumption outlays, and (2) a reduction in basic or standard income-tax rates in order to increase private spending.

If the foregoing analysis is correct, private outlays, whether for consumption or for investment, cannot be relied upon automatically to provide a volume of aggregate demand adequate to achieve and maintain full employment. An expansion of public outlays in areas in which there are serious deficiencies in our society is necessary. These outlays, in turn, would have a magnified effect on aggregate demand, by inducing an increase in pri-

[4] See Chap. XIV in this book.

vate consumption expenditures and also by raising the *normal* rate of private capital formation. In addition, once the public budget has reached a level agreed upon as desirable in view of the most urgent needs—social priorities—the structure and rates of taxation should be established (and adjusted cyclically) so as to ensure a volume of private outlays, combined with the public outlays, adequate to maintain full employment.

The analysis given above should make it clear that to reach and maintain an adequate volume of aggregate demand involves something much more than an indiscriminate adding together of the total of private consumption and private investment with public outlays sufficient to reach a desired total. It involves a balanced relationship between private consumption and private investment on the one side, and between public outlays and private outlays on the other. The wise use of public outlays will aid in maintaining an appropriate balance between private consumption and private investment. Also it is necessary to maintain a proper balance between private outlays and public outlays in order to achieve the highest degree of welfare in terms of social priorities and the best use of resources.

PART THREE

GOVERNMENT DECLARATIONS AND PROGRAMS

Chapter V

England

IN MAY, 1944, the Churchill government issued a pioneering and forward-looking White Paper on Employment Policy Yet before there had been any opportunity to put the program into effect the victory of the Labor party in July, 1945, made it evident that the country had already moved far beyond the White Paper of 1944.

In the meantime—June, 1944—Sir William Beveridge had published a report of his own on Full Employment in a Free Society. In this report he took the Government to task for being far too inhibited in its statement both of goals and of means. The Government, he said, had not faced the implications of the experience either of peace or of war. It had, indeed, within the limits of its social philosophy, made a sincere attempt in the White Paper to deal with the disease of unemployment. The Government in its diagnosis had understated, he thought, the seriousness of the disease, and the practical proposals he regarded as inadequate. The Government, he felt, was inhibited by a sense of values wrong in two respects: (1) of treating private enterprise as though it were a sovereign partner independent of the State, and (2) of regarding a balanced budget as of equal importance with full employment. Thus he regarded the Government's declaration of war against unemployment as a "war with reservations"—a "business-as-usual" war. In contrast Sir William concluded his book with the declaration: "The time calls for total war against unemployment and other social evils, not for a war with inhibitions." As Sir William saw it, such a war could be waged by a free society without losing the traditional personal liberties of the democratic political state. It could, moreover, be waged, he thought, without resort to socialism.

The Labor party won a sweeping victory in July, 1945. With a large majority in Parliament, it is planning, in its 5-year tenure

of office, a comprehensive program involving the nationalization of certain industries and other matters not directly related to employment. But there can be no doubt that the Labor government is prepared to accept Sir William's challenge with respect to an all-out war on unemployment and the other giant social evils of want, disease, squalor, and ignorance. Moreover, the proposed widening of the role of public enterprise into areas long occupied by the state in Sweden, for example, will have important implications with respect to employment policy.

But while political events in England have already outmoded the famous White Paper on Employment Policy, this notable state paper is still worthy of careful study. This is true not only because the policies that it advocates will inevitably become a part of the arsenal that any government must employ in its war upon unemployment, but also because no government can afford to discount or overlook the difficulties and obstacles in the path toward full employment which are disclosed in that document.

A New State Responsibility.

It is recognized in the White Paper that the program there outlined represents a novel experiment and involves a new approach and a new responsibility of the State. The opening sentence states: "The Government accept as one of their primary aims and responsibilities the maintenance of a high and stable level of employment after the war." No British Government had undertaken such a responsibility before.

The White Paper and the Beveridge Report are agreed that the problem of mass unemployment is not likely to afflict England for some years. The destruction caused by the war; the great shortage of houses; the need for replacement of worn-out railroad equipment and industrial machinery; the deferred demand of war-starved consumers; the need to replenish retail shelves; and, finally, the urgent necessity to rebuild the export trade—all those will keep the wheels of industry humming for some time. There will accordingly be no need to put into operation the long-term policy of averting mass unemployment. Indeed, for a time it will be necessary to exercise restraint on private spending. The job of reconstruction, of rebuilding the cities, will require not only large private capital outlays, but also an unprecedented volume

of public investment. It may thus become necessary to curtail unnecessary private investment and even to hold in check private consumption expenditures. To do so will involve, not only rationing, allocation of raw materials, and price control, but also a level of taxation to check private spending on a scale that is likely to produce a budgetary surplus.

"Sound Finance" in the Restocking Boom.

Under conditions of over-all scarcities, modern fiscal policy demands a rate of taxation adequate to hold inflationary tendencies in check. But devotees of orthodox finance are likely to regard any budgetary surplus as evidence of a deliberate return to a so-called "sound finance" policy. If a budgetary surplus is achieved in England and the United States during the period of war-created scarcities, we shall doubtless hear many arguments to the effect that it is in fact the budgetary surplus itself which is responsible for the condition of full employment. Probably the war-created scarcities will last longer in England than in the United States. If depression and mass unemployment strike here first, as is not unlikely, this country will experience an unbalanced budget together with unemployment, while England with full employment will still be running a budgetary surplus. Under those circumstances it is not difficult to forecast that the devotees of "sound finance" will invert cause and effect. They will argue that Britain is enjoying full employment *because* she has a balanced budget; while the United States is suffering unemployment *because* her budget is unbalanced. And a deliberate program to unbalance our budget further still, in order to fight unemployment, will be vigorously resisted by arguments pointing to the budgetary and employment position in England.

Nevertheless, the White Paper on Employment Policy warns that, even in Britain, it may not be very long before production may become adequate to meet the various postwar calls upon it. When this happens, the maintenance of an adequate level of expenditure on goods and services "will no longer be realized automatically," as a by-product of war or of reconstruction, but will call for the application of a policy deliberately directed to that end.[1]

[1] *Employment Policy,* Cmd. 6527, p 10.

Three Conditions of Full Employment.

In Sir William's report three conditions of full employment are elaborated, as follows: (1) adequate total outlays, (2) controlled location of industry, (3) organized mobility of labor.

Adequate Outlay.

The central proposition in his book is that the responsibility of ensuring at all times outlays sufficient to provide full employment must be placed formally by the people of Britain upon the Government. The assumption of this responsibility by the Government is indeed the meaning of adopting a national policy of full employment

On this point there is fundamental agreement. The White Paper states that "the first step in a policy of maintaining general employment must be to prevent total expenditures from falling away." Again: "A country will not suffer from mass unemployment so long as the total demand for its goods and services is maintained at a high level." The first condition of full employment is adequate aggregate outlays, public and private. "Total expenditure on goods and services must be prevented from falling to a level where general unemployment appears." [2]

But neither the Beveridge Report nor the White Paper is guilty, as some critics have asserted, of expressing the superficial view that full or high levels of employment can be achieved merely by plenty of public and private spending. It will "not be enough to rely on the general maintenance of purchasing power to solve all the problems of local unemployment." [3] Merely to increase aggregate demand in an effort to cure pockets of unemployment in stranded areas would likely produce inflation. Jobs and workers must be brought together. While the problem of depressed areas will certainly be less recalcitrant if general purchasing power is adequate, a direct attack on the problem is nevertheless necessary. A solution on the lines of adequate aggregate demand "would be too long drawn out and might involve the partial depopulation of industrial regions which are a national asset that we cannot afford to lose." [2]

[2] Cmd. 6527, pp. 3, 15, 16.
[3] Cmd. 6527, p. 11.

Control of Location.

Beveridge, even more than the White Paper, presses home the point that to solve the problem of full employment, it is not enough merely to provide adequate total outlays; it is also necessary to control the location of industry. He adduces from his exhaustive analysis of the British employment data the interesting conclusion that British labor is highly mobile with respect to movement from industry to industry, but immobile with respect to movement from region to region. He argues, drawing upon the reports of the Barlow Commission on the Distribution of the Industrial Population, that the controlled location of industry is of the utmost importance, not only from the standpoint of rational planning of land use, but also from the standpoint of solving the problem of structural unemployment.

In the decades between the two world wars, industry became increasingly concentrated around the London area, leaving populations stranded in other parts of the country. This concentration of industry was not only highly dangerous from the standpoint of national security, but it also involved serious social disadvantages and costs to the community as a whole.

The disadvantages in the flow of population to the great congested cities include the higher mortality of the great cities, the congestion and discomfort of the living conditions in them, the congestion and discomfort of transportation, and the costs involved to mitigate each of these three disadvantages.

The Commission's Report, in Sir William's judgment, makes an unanswerable case for national planning of the location of industry. This conclusion, he thinks, is greatly reinforced by the damage to the districts that are left derelict and the social costs that are involved in the transfer of huge populations. Some minor economic advantages may indeed flow to the individual entrepreneur who locates his industry in the great centers, but this may be far more than offset by the general community costs, both of a social and economic nature, involved. There remains, moreover, the final difficulty that populations just will not readily move.

To some American readers the control of location of industry as advocated by Beveridge has seemed to be a serious invasion of

personal liberties. This reaction is doubtless partly due to unfamiliarity with the progress of town and country planning in England or even of city planning in the United States. Detailed project area planning, which specifically restricts the uses of each piece of land, together with the more general control of the use of land in the entire urbanized area, far from encroaching upon individual or property rights, are in fact important and necessary means to safeguard values and to ensure a sound development. This is increasingly recognized by those who are familiar with the chaotic conditions, leading to spreading blight and deteriorating land values, resulting from wholly unplanned land use.

The White Paper also stresses the importance of control of industry location as a necessary instrument of employment policy. It points out that the war experience has shown that production can be as efficient in the depressed areas as in other parts of the country. Much social capital—houses, shops, public services—are already located there. This should not be sacrificed lightly. There are indeed certain areas that, because of the exhaustion of natural resources, or other special factors, offer no hope for sound revival. In these special cases, some part of the population may need to be reestablished elsewhere. "But where a large industrial population is involved, the Government are not prepared either to compel its transfer to another area or to leave it to prolonged unemployment and demoralization." [4]

With respect to the "second condition" of full employment, then, there is a large measure of agreement between the Beveridge Report and the Government's White Paper. Both agree that industry needs to be taken to areas where there are large populations suffering from unemployment. Reliance cannot be placed upon uprooting populations and moving them elsewhere.

In the White Paper it is declared to be an object of Government policy to secure a balanced industrial development in areas specially vulnerable to unemployment. To this end it is proposed to encourage the establishment of new industries in "development areas" by various means. The Government should exercise a "substantial control over location of new industrial development, as contemplated by the Barlow Report." The Government will give priority to the "development areas" in granting licenses

[4] Cmd. 6527, p. 12.

for building new factories or extending existing factories. The Government will continue and extend the policy of erecting factories for sale or lease in "development areas." The Government, in order to promote the most desirable location of industry, will give due regard to area needs in placing Government orders of all kinds. The Government will ensure that enterprises that establish themselves in those areas "shall have adequate facilities for obtaining short-term and long-term loans and, when necessary, share capital." [5]

Labor Mobility.

Equally, there is agreement about the need for labor mobility to ensure that the supply of labor will match the demand for labor. While industry should as far as feasible be brought to where people live, "in an expanding economy workers must be ready and able to move freely between one occupation and another." [6] The expansion of new industries under the stimulus of a high level of demand must not be hampered by a shortage of skilled labor. The Government had already announced training schemes for resettling ex-Service men and women and released war workers. These it was now proposed to continue as a permanent measure so as to assist persons from one industry or occupation to another. Training allowances, higher than unemployment benefits, were suggested. The Government, moreover, expressed the belief "that, with the creation of conditions designed to produce full employment and stability, all parties in industry will agree that existing rules and practices may safely be modified to allow the ready admission of trainees. . . ." [7]

The Government indicated that, while not intending to rely primarily on large-scale labor transfers to other areas, it wished nevertheless to facilitate transfers to places where suitable employment is available. Experience before the war indicated that the two most serious obstacles to such transfers were (1) difficulty in obtaining a suitable house to rent and (2) special costs of moving. The Government announced that steps would be taken to provide houses at a reasonable rent and that workers transferred

[5] Cmd. 6527, p. 12.
[6] Cmd. 6527, p. 13.
[7] Cmd. 6527, p. 15.

under approved schemes to new areas will be eligible for "resettlement allowances."

Thus mere expansion of total expenditure is not enough. If such expansion "were applied to unemployment of a type due, not to absence of jobs, but to failure of workers to move to places and occupations where they are needed, the policy of the Government would be frustrated and a dangerous rise in prices might follow [8]

Beveridge's recommendations are substantially similar in character. The organized mobility of labor relates, as he sees it, fundamentally to the movement of labor from trade to trade and from industry to industry. The compulsory use of employment exchanges should, Sir William thinks, clearly be imposed upon the juvenile workers. This would facilitate the controlled flow of adaptable juveniles to expanding industries and prevent their drifting into blind-alley occupations. Obstacles to the fluidity of labor must be removed, particularly restrictions on entry to specific trades and the unwillingness of the individual to change his job. Both of these ends could be achieved only in an environment of expanding demand and full employment. Under these conditions restrictions on entry can be removed; and the individual, provided by the State with facilities for training and reasonable assurance of obtaining employment, will be less reluctant to change his occupation. Organized mobility means flexibility of the labor supply and sufficiency of demand. It does not imply that all working people will be under the continual necessity to change their jobs and places of work. Most people should continue normally in their chosen occupations and their settled homes. Organized mobility does not mean perpetual motion, but it does mean that labor, in accordance with the requirements of a dynamic economy, shall move rapidly and directly to new jobs when there are new jobs.

Price Stability.

To Beveridge's "three conditions of full employment" should be added a fourth—one particularly stressed in the White Paper, and in fact not overlooked by Beveridge himself. I refer to the stability of prices and of labor costs. In the White Paper the

[8] Cmd. 6527, p. 20.

phrase is "stability of prices and wages." This terminology is, I think, unfortunate, though the substance of what is said is admirable. By "stability of wages" the Government made it clear that it was not intended that wage rates must remain fixed, but rather that "increases in the general level of wage rates must be related to increased productivity due to increased efficiency and effort." [9]

Since in fact it is expected that wage rates should be increased in line with increased productivity, a better phrase would have been "stability of prices and labor costs." Indeed, prices cannot be kept stable unless wages are kept within the limits of increases in productivity. Thus stability of labor costs (not of wage rates) and stability of prices are intimately interrelated.

"Thus a stability of these two elements is a condition vital to the success of employment policy. . . ." [9] Merely to maintain adequate total outlays will be fruitless if labor costs and prices are not kept reasonably stable. Only so can "increased expenditure provided at the onset of depression" go to increase the volume of employment. "Employers, too, must seek in larger output rather than higher prices the reward of enterprise and good management." If the "manufacturers in a particular industry were in a ring for the purpose of raising prices, additional money made available by Government action for the purpose of maintaining employment might simply be absorbed in increased profit margins and no increase in employment would result." [9]

Beveridge devotes a section of his report to the internal implications of full employment—wages, industrial discipline, price policy, and monopolies. "There is a real danger," he says, "that sectional wage bargaining without regard to its effects upon prices, may lead to a vicious spiral of inflation with money wages chasing prices and without any gain in real wages for the working class as a whole." If prices are kept stable, as he suggests, rising productivity will make possible a continuous rise of money wages. [10]

Wages ought, Beveridge thinks, to be determined in the light of all the facts, not simply by bargaining power. Collective bargains should include a clause for arbitration. In a free society "men should not be imprisoned for striking, though they may

[9] Cmd. 6527, p. 19.
[10] William H. Beveridge, *Full Employment in a Free Society*, pp 199-200.

rightly be deprived of all support if the strike is contrary to a collective bargain or an agreed upon arbitration." [11]

The State should adopt, Beveridge argues, a definite policy of stable prices. Trade unions cannot be expected to accept a reasonable wage policy, unless there is some assurance of stable prices. A limited degree of price control may be necessary, but this can be restricted to essential goods and services and upon goods temporarily in scarce supply. "When concentrated in this fashion, the problem of price control presents no insuperable administrative difficulties." [12] High levels of output under the stimulus of full employment will help to minimize the difficulty of preventing prices from rising. "Industrial progress tends to lower prices, while the bargaining of labor tends to increase prices. These two opposite tendencies can be held in balance in a progressive society, if all classes cooperate willingly." [13]

Control of Monopoly.

Full employment, he thinks, might reduce the problem of monopoly practices. The restrictive practices of business and of trade unions are often measures of defense against deficiency of demand.

Three stages of control of monopoly are outlined in the report. The first type involves simply the obtaining of information; the second, regulation; and the third, public ownership. This final stage may become necessary if an industry is by nature a monopoly or if monopoly persists. If this is the case, the simplest way, Beveridge believes, to ensure the public interest is to make it a public service under a public corporation.[14]

Little control will be needed if private citizens use their liberties with a high sense of social responsibility. If trade unions press for unreasonable wage claims, wage determination will tend to become a function of the state. If private owners of business ex-

[11] William H. Beveridge, *Full Employment in a Free Society,* p. 200.

[12] When inflationary developments threaten, the National Investment Board should have powers to veto projected private investment projects, if investment activity threatens to get out of hand. Moreover, working overtime in some sectors might release the pressure of demand if bottlenecks developed. *Ibid.,* p. 202.

[13] *Ibid.,* p. 203.

[14] *Ibid.,* p. 204.

ploit consumers by organizing monopolies, state ownership of such businesses will likely be undertaken. "All liberties have their responsibilities. The greater the sense of citizen responsibility, the greater can be the measure of liberty and the scope that is left for agencies independent of the State." [15]

This section of Sir William's report cannot fail, I think, to take on new significance now that the British Labor Party has assumed control of the Government.

Stabilizing the Cycle.

Having surveyed the "conditions of full employment"—(1) adequate total demand, (2) control of location, (3) labor mobility, and (4) stability of prices and labor costs, we must now revert to the first and basic condition—the maintenance of aggregate outlays for goods and services. How can this condition be achieved?

It would of course be an easy matter for the Government merely to spend enough at all times to keep aggregate outlays at the desired level. But to ensure that public expenditure shall (1) be useful and productive, (2) be administered in a manner so that productive resources shall be used efficiently, (3) bear a proper relation to private outlays in terms of social priorities, (4) be of a character that can absorb those thrown out of work by reason of fluctuations in private-capital outlays, and (5) be financed so as to maintain stability in the value of money—all this is no easy matter. The practical problems of administration and control are grave indeed.

In the White Paper the Government is fully cognizant of these difficulties. It notes that variations in private expenditure on capital equipment and the foreign balance are the greatest and at the same time most difficult to control. Moreover, an increase in one part of expenditure can only within limits offset a decrease in another. The most serious obstacles to the maintenance of total expenditures lie in these highly inconvenient facts.

Accordingly, the guiding principles of Government policy, as outlined in the White Paper, involve an effort (1) to avoid an unfavorable foreign balance by means of international cooperation to sustain a high level of world trade, (2) to do everything possible to limit the swings in private-investment expenditure,

[15] *Ibid.*, p. 207.

(3) to plan ahead public investment so as to offset as effectively as possible unavoidable fluctuations in private investment, and (4) to be prepared to *check* and *reverse* the decline in expenditure on consumers' goods that normally follows as a secondary reaction to a falling off in private investment.[16]

Accordingly, the Government proposed to encourage private enterprise to *plan* its own capital expenditure. It was felt that the larger enterprises could follow the example set by the Government in the timing of investment in conformity with a general stabilization policy. A wider understanding of the social importance of employment stability should reinforce the interest that business has in stabilizing private capital expenditures. Moreover, the Government could provide a direct inducement by appropriate tax devices.

But when all is said and done about stabilizing private investment, there can be no doubt that fluctuations will still occur. Thus public investment must be used directly as an instrument of employment policy.

But here serious practical difficulties are encountered. Only a small proportion of public capital outlays are made by the central government; by far the greater part is made by local authorities and public utilities. In the past these have followed the cycle. It should at least be possible for Government to stabilize its own investment expenditures. But this may not be enough. Public investment should expand when private investment is declining. But there are practical limits to this policy. A large part of public capital outlays—schools, hospitals, housing—is dictated by urgent public needs.[17] They cannot readily be postponed. Moreover, the central government, without much more power of direction than is now possessed, is not in a position to control the whole of public investment (central and local) in a coordinated fashion. Thus there are limits to the policy. But within these limits something can be done to order public investment so as to offset in a measure the fluctuations of private investment.

[16] Cmd. 6527, p. 18.

[17] This point is stressed still more by Beveridge. "But the demand for roads and houses as well as for most other forms of publicly controlled investment (sewerage, public utilities, schools, hospitals, etc) is intimately linked with the general economic activity of the nation" (p. 182) The amount of public investment that is postponable at the highest is likely to be sufficient only to compensate for fluctuations in overseas demand (p 183).

If anything of value is to be done, it will be necessary that local authorities shall submit to the central government a program of capital expenditures for, say, the next 5 years. The plans must be worked out in detail and ready for immediate execution. These programs must then be assembled by an appropriate coordinating body. The programs will then be adjusted upward or downward in the light of the prospective employment situation. If a slowing down is necessary, loan sanctions or central-government grants should be withheld. If an acceleration is indicated, the Government should be prepared to bring forward projects and to facilitate their financing by loan sanctions or by grants. A programing of capital expenditures by public-utility companies should be worked out along similar lines. In this manner the Government should be able to set a target each year for the whole volume of public works in the succeeding year.[18]

Checking a Downturn.

The Government expresses the belief that in the past the power of public expenditure to check the onset of a depression has been underestimated. What is needed is to press forward quickly with public expenditure when incomes are falling and the outlook is dark. Such action has in the past been resisted, but this resistance can be overcome "if public opinion is brought to the view that periods of trade recession provide an opportunity to improve the permanent equipment of society by the provision of better housing, public buildings, means of communication, power and water supplies, etc." [19] The crucial moment of intervention is the first onset of depression. Once the decline has spread and gathered momentum, interventions on a much grander scale would be required. The Government therefore announced that it was "prepared to accept in the future the responsibility for taking action at the earliest possible stage to arrest a threatened slump." [20]

Stabilizing Private Investment.

Private investment and the foreign balance, all are agreed, are the seriously fluctuating and uncertain elements in total outlay. Sir William believes, however, that it is possible to achieve

[18] Cmd 6527, p 21.
[19] *Ibid.*, p. 22.
[20] *Ibid.*, p. 16.

through the regulation of a National Investment Board a high degree of stability in internal private investment. He thinks it is more difficult to control the foreign balance, since overseas demand is not subject to British control.

Accordingly, a compensatory policy by the State will be needed, which involves a cardinal break with two main principles that have guided governments in the past; first, that State expenditure should be kept down to the minimum necessary to meet inescapable needs and, second, that Government income and expenditure should balance each year. Once the possibility of deficient private demand is admitted, the central government, if it aims at full employment, must be prepared if need be to spend more than it takes away from the citizens by taxation.[21]

Sir William lays relatively little stress on the compensatory feature, and he is critical of the British White Paper on Employment Policy for viewing the problem mainly in these terms. He believes that if a long-term policy of planned public outlay (involving a systematic attack upon the giant social evils of want, disease, squalor, and ignorance, and including an adequate program of public construction and public investment) is undertaken, cyclical fluctuations will be greatly reduced. Sir William's report proceeds on the basis of planning for a continuous steady expansion rather than on the basis of mitigating fluctuations.[22] He stresses a long-term expansionist program including the growth of consumption demand, which should help to maintain private investment, the stabilization of the prices of primary products to minimize fluctuations in overseas demand, the stabilization of private investment through a National Investment Board using powers of control and loan and tax policy, and, finally, the expansion of the public sector of the economy in terms of social services and public investment so as to enlarge the area within which investment can be stabilized directly.[23] Cyclical stabilization he regards as a by-product in the main of a long-term expansionist program. *Fluctuation* of demand he regards as secondary to the central weakness of the unplanned market economy, namely, the *chronic deficiency* of demand. While the British

[21] Beveridge, *op. cit.*, p. 136.
[22] *Ibid.*, p. 263.
[23] *Ibid.*, p. 271.

White Paper stresses the *timing* of demand, Sir William is mainly concerned with the *expansion* of demand.[24]

Fears of unemployment will not be allayed merely by promise of attempts to control the trade cycle. Apart from the trade cycle, the long-term building cycle may lead to long-term unemployment, and measures specifically directed toward this industry are necessary. This involves a "long-term programme of effective demand for building construction, guaranteed by the financial power of the State." [25] Apart from the idea of directly offsetting fluctuations in private capital outlays, a large extension of public investment has a far more fundamental role to play, namely, "to make steady development on a long-term programme possible over a larger field." [26]

The White Paper, while stressing the cyclical aspects of unemployment, recognizes that the goal of full employment cannot be achieved merely by "controlling" or "offsetting" private capital outlays. A direct attack must be made on private consumption expenditures. The White Paper declares that, despite all efforts, there will still be swings in private capital outlays, and these fluctuations will, in turn, by reducing incomes, cause people to lower their consumption expenditures.

Stabilizing Consumption.

Accordingly, in addition to offsetting the decline in private capital outlays by means of an increase in public investment, it is proposed in the White Paper to "create another line of defense" by influencing the expenditure on consumption. Here again speed is essential. The ideal is therefore "some corrective influence which will come into play automatically . . . in accordance with rules determined in advance and well understood by the public." [27]

The Government favored the adoption of a scheme for varying the weekly social-insurance contributions of employers and employees. The *standard* rate would be set at a figure such as to keep the social-insurance fund in balance over a number of years. But

[24] *Ibid.*, p. 269.
[25] *Ibid.*, p. 182.
[26] *Ibid.*, p. 183.
[27] *Employment Policy*, Cmd. 6527, p. 22.

the rate actually levied would exceed or fall below the *standard* rate according to whether unemployment fell below or rose above the estimated average level. Thus, as an illustration, if unemployment were less than 5 per cent, the standard rate of contributions would apply. If unemployment rose above 5 per cent, the contributions paid would be cut successively at intervals of two points in the unemployment percentage. At an unemployment rate of over 11 per cent, the joint contributions would be cut in half. The effect, it is estimated, would be to reduce the fall in aggregate demand by one-quarter compared with what it might otherwise have been. The additional money left in the hands of millions of employed workers would help to maintain the demand for consumers' goods and would in part offset the decline in expenditure of those who had lost their jobs.[28]

The Government had also considered other devices for influencing the volume of consumption, including (1) direct variation in tax rates and (2) a system of deferred credits. The latter scheme is preferred. Under it excess taxes collected in good times would be treated as a credit repayable to taxpayers in bad times, but *tax rates* would remain unaltered throughout the cycle.

In addition, it is suggested that the Government might directly sustain employment in consumers' goods industries by placing orders when demand was flagging. The Government is normally a large purchaser of certain types of consumers' goods—shoes, clothing, and furniture. Orders could be varied according to the state of employment. Local units of government could be invited to do likewise. If all governmental bodies adopted the policy of buying for stock when employment was low and drew on these stocks when trade was brisk, some contribution could be made toward employment stability.

The Government might go further and place orders for consumers' goods not required for Government use. Such purchase would involve resale to the public and would entail the risk that stocks would overhang the market. Yet for some classes of goods the scheme, it was believed, might be possible, and at any rate deserved further study.

In addition, consumer expenditures might be stabilized over the cycle by regulating consumer credit.

[28] *Employment Policy*, Cmd. 6527, p. 23.

Beveridge's long-term program of planned outlays includes programs to increase private consumption both by measures to increase the national income and by the redistribution of income through social security and other welfare expenditures, and through progressive taxation. But he interposes several serious objections to the proposal to place adequate purchasing power in the hands of citizens as the main instrument of a full-employment policy.

He objects to variations in social-security contributions on practical and psychological grounds. He thinks that the advantages are not very great, and at the most could only mitigate the secondary effects of fluctuation in employment. If tried out, it should only apply to the contribution of employees, since employers may not spend more if their insurance costs are reduced. A better case could be made out, he believes, for varying the income-tax rates.

"Some re-distribution of private incomes, increasing the propensity to consume, should be a part of a full employment policy." [29] Nevertheless Sir William prefers, in the interest of wise direction of demand, to stress community outlays on housing, health, education, and nutrition in order to abolish the giant evils of want, squalor, disease, and ignorance, and to raise the standard of life of future generations. To establish an adequate "social minimum," free community services must be provided on a substantial scale. Public outlay should be looked upon as a "weapon against giant social evils, not as a gap-filling device to take up the slack of private outlay." [30]

Bulk Purchases and Subsidies.

In his long-range program of planned outlay, in addition to the customary expenditure areas, Sir William makes an interesting new proposal. He advocates the method of "joint outlay" under which essential consumption goods such as food, fuel, clothing, furniture, and standard house equipment would be supplied to private citizens at low cost. While the ordinary private channels of retail distribution would be left undisturbed, the State would take over more and more the general business of wholesaling.

[29] Beveridge, *op. cit.*, p. 186.
[30] *Ibid.*, p. 158.

Through bulk buying, substantial reduction in price might be achieved and, if need be, the price might be lowered still more by a subsidy. Bulk purchases of food from overseas would constitute a part of this program.

A program of expanding consumer demand, social and private, would tend to reduce the cyclical swings in private investment. Nevertheless, Beveridge believes that the indirect effect of a program of expansion will not alone produce stability. In addition it will be necessary *directly* to stabilize private investment through a National Investment Board using "powers of control and loan and taxation policy." Moreover, the "expansion of the public sector of business" will enlarge the area within which investment can be stabilized directly.[31]

The fundamental difference in emphasis—stability vs. expansion; stable employment vs. full employment—has its counterpart in the financial programs contained in the White Paper and in the Beveridge report. The former implements fiscal policy in terms of the cycle; the latter in terms of a sustained program to conquer the giant social evils—want, disease, squalor, and ignorance.

Loan Financing.

The main proposals in the White Paper do not necessarily involve a deficit in years of subnormal trade activity. Many of the measures proposed not only involve no deficit but indeed help to reduce the need for one. A low-interest-rate policy is no burden on the budget.[32] Any action to improve the foreign balance helps the budget. Variations in the capital position of the social-insurance fund will not affect the revenue budget. Central government aid to local bodies to expand capital outlays will take the form of annual grants toward meeting the fixed charges on loans, and so the burden is spread over many years. These measures, if they succeed in stabilizing the national income, will help to iron out budget deficits.

Nevertheless, it is not intended to balance the budget each year regardless of the state of business activity. "Such a policy is not

[31] Beveridge, *op. cit.,* p. 271. The stabilization of the prices of primary commodities is also regarded as essential.

[32] The full fiscal implications of a continuously low rate of interest do not appear to have been adequately taken account of in the White Paper.

required by statute, nor is it part of our tradition." [33] The Chancellor of the Exchequer, in future as in the past, is free to take account of trade and employment conditions in framing his annual budget. Policies proposed in the White Paper may involve deficits in a particular year, but there is no thought of departure from the principle that the budget must be balanced over a longer period.

Whatever may be said of this alleged "principle," it is at any rate a fact that a leading characteristic of British financial history is a vast growth in the public debt during the last 250 years. In 1714 the debt stood at £55,000,000; in 1748 at £78,000,000; 1786 at £257,000,000; 1815 at £848,000,000; 1918 at £7,830,000,000; and in 1946 at £24,500,000,000. And this, it should be noted, was mainly "dead-weight" war debt which, according to the White Paper, should be reduced while "productive" debt might be permitted to grow.

The White Paper does indeed state that "proper limits on public borrowing also depend on the magnitude of the debt charge in relation to the rate of growth of the national income, In a country in which money income is increasing, the total debt can be allowed to increase by quite appreciable amounts without increasing the proportionate burden of the interest on the debt." [34]

It is also recognized that much public capital expenditure is remunerative in a commercial sense and will amortize itself. Other kinds of capital assets—roads, schools, parks—yield no income. But in modern countries borrowing for such projects is, with certain limits, regarded as normal practice. In the case of local units of government, no intolerable tax burden need result if a proper relation is kept between capital outlays and the buoyancy of tax revenues. If the central government, for reasons of employment policy, should urge upon local authorities additional capital out-

[33] Cmd. 6527, p. 25.

[34] *Ibid.*, p. 25. According to the White Paper, it is expected that the debt will continue to grow for some years after the war owing to the capital outlays needed for reconstruction and the necessity of reducing tax rates. But while the productive or semiproductive debt will grow, the Government hoped to begin to reduce the "dead-weight war debt." Reference is made to a "policy of steadily reducing the dead-weight debt, while other forms of debt are increasing. . . ."

lays, the Government expressed readiness to give further financial assistance.

The White Paper recognizes that a budget deficit may turn up as an unwilling guest in times of depression. But while recognizing the need to maintain the national income, the Government stated that it would equally have in mind the "need for a policy of budgetary equilibrium." Just how it would resolve this riddle was however nowhere explained.

Sir William chides the British White Paper on Employment Policy for being still far too inhibited in regard to finance.[35] Taking account of careful estimates of the probable secular rise in national real income if Britain adopts a controlled program of expansion, Sir William shows that a policy of borrowing on a scale adequate to sustain full employment would be quite consistent with a steady reduction of the burden of debt to the taxpayer. In other words, while the national debt would rise, it would not (even though all probable requirements were met) rise as fast as the tax revenue derived from the expected growth in the national income.[36]

Routes to Full Employment.

Among the novel features of the book is the discussion of alternative routes to full employment. Starting from the depressed condition of Britain in 1938, he discusses how the gap between the realized total public and private outlays and the required full-employment outlays might be filled. What routes might she have taken, starting with the relatively low level of 1938, in order to achieve full employment? As outlined by Sir William, Route I would involve an increase of public outlay, leaving tax rates unchanged. This method would at once create a budgetary deficit. The increased public outlays, through the ensuing rise in employment, could be expected to increase private consumption expenditure by an amount that could within narrow margins of error be calculated. It might also induce some increase (difficult to estimate) in private investment outlays.

Appendix C in the Beveridge Report contains statistical estimates made by Mr. Kaldor on the fiscal implications of the three

[35] Beveridge, *op. cit.*, p. 264.
[36] *Ibid.*, p. 148.

routes to full employment. Starting with the data as of 1938, he shows that at full employment *public outlays* would have constituted 21 per cent of total outlays if Route I (increase in public expenditures with tax rates unchanged) had been used; 33 per cent with Route II (balanced budget with increase in both outlays and tax rates); and 15 per cent with Route III (public outlays unchanged with tax rates reduced). Under Route I the Government deficit would have amounted to 4.4 per cent of total outlays, and 6.6 per cent under Route III.[37]

The tax-financing method of expansion (Route II) involves the largest public outlays, but no deficit. It will be preferred by those who fear most an increase in the public debt. The tax-reduction method (Route III) involves the lowest volume of public outlays, but the largest deficit. It will be preferred by those who fear most an undue expansion of public functions. The loan-financing method (Route I) lies in between and avoids the extreme of both large expenditures and large deficits.

Route III (tax-reduction method) applied to the conditions of 1938 would certainly have involved a smaller public outlay than was needed to conquer the giant social evils of want, disease, squalor, and ignorance.

Social Priorities.

Sir William is not content merely to ensure that the State shall make outlays on current services and public investment adequate to raise the total demand to a full-employment income; such a policy would indeed ensure full employment, but it would not necessarily ensure the highest attainable standard of living or the best use of productive resources. He is vitally interested not merely in adequate total demand (which, to be sure, is the first categorical imperative) but also in social priorities, namely, the wise direction of outlay. In order to end the giant social evils, and in order to raise the productive power of the community, it may well be necessary that the public outlays in the total national budget be greater than the amount necessary to create an adequate total demand. Private consumption and private investment may accordingly, especially in the reconstruction years, have to be

[37] *Cf.* Arthur Smithies, "Full Employment in a Free Society," *American Economic Review,* June, 1945.

restrained in order to do the things that are most urgently necessary. Sir William is not content to relegate public outlays to the minimum residual necessary to maintain adequate total demand. While the first rule—adequate total outlay at all times—is absolute, the second rule—wise direction of outlay—is hardly less important.[38]

On the other hand, Route II (tax-financing method) would probably have involved a larger public outlay than could be justified on the ground of social priorities.

In general, Sir William favors as a rough guide (though of an altogether minor order of importance)[39] the rule that the current services of Government should be paid by taxation, while public capital expenditures—the production of durable goods such as houses, hospitals, schools, means of transport, and the like—are regarded as the natural subject of borrowing.[40] It would be dangerous, however, as Sir William is careful to point out, to stick closely to such a rule at all times. The ratio of tax revenues to expenditure should be based, not on considerations of finance and budgetary equilibrium, but on broad grounds of social and economic policy.

Criteria with Respect to Budget Balancing.

Full employment, it is evident from this analysis, can be achieved on the basis of either a balanced or an unbalanced budget. It is often said that it may be necessary to unbalance the budget in order to reach full employment. From the short-run standpoint this may indeed be true, for the reason that this method involves smaller public outlays and in practice it may be difficult to increase public outlays quickly to the required amount. But from the long-run standpoint, an unbalanced budget is not a prerequisite to full employment.[41] The ultimate criterion relates to the desirable volume of public outlays in relation to private outlays in terms of social utility. Once this is determined upon, the next consideration relates to the desirable structure of taxation,

[38] Beveridge, *op. cit.*, p. 147.
[39] *Ibid.*, p. 147.
[40] *Ibid.*, p. 149.
[41] Some of my critics have overlooked the fact that this was already clearly stated in my *Fiscal Policy and Business Cycles*, published in 1941; see, for example, pp. 182-185.

again in terms of social utility. Once these two matters have been settled upon, the effect on the budget may turn out to be a deficit, a surplus, or a balance. If some particular budgetary position is insisted upon, it might be necessary to sacrifice either full employment or the best use of resources in terms of optimum utility.[42]

Problems of Administration.

With respect to the Government machinery necessary to implement a program of full employment, Sir William proposes a departmental organization in three tiers corresponding to the three functions:

1. The planning of total outlays, public and private, sufficient to provide full employment.
2. Ensuring that the best possible value is obtained for the outlay by efficiency and economy of administration, and
3. The function of actually making the outlay for the various purposes included in the national program.

Accordingly, he proposes a Ministry of National Finance to determine outlay, a Department for Control of Public Expenditure (the Treasury) to ensure good value for outlay, and a number of executive departments under the supervision of the Department of Control. To control the location of industry, there should be established a Ministry of National Development, including the whole field of town and country planning, housing, and transport. The Ministry of Labor should undertake the administration of the organized mobility of labor.

The Ministry of National Finance would have the duty of preparing the national man-power budget. It would be concerned not only with the outlay of the State, but also the outlay of private citizens for consumption and business investment. Consumption outlay can be influenced by taxation and price policy. Private investment can be integrated with public investment through such spheres of economic activity as housing and town planning, public utilities, transport, agriculture, and each of the major industries. These plans can be worked out under the initiative and guidance of the State in cooperation with the industries concerned. Sufficient investment projects should be elaborated to provide for the needs years ahead, so as to permit the timing of

[42] *Cf.* Smithies, *op. cit.*, p 359.

their execution and ensure a steady flow of capital expenditure for the national economy as a whole. Investments undertaken by the central government, the local authorities, public utilities, and private industry should be coordinated in accordance with the scale of priorities into a single national plan.[48]

For the execution of the national budget there will be needed a new organ, the National Investment Board. In addition to direct public investment, the Government should give assistance by ensuring, through Government guarantee, a low rate of interest for approved investment purposes. This would be of critical importance, particularly in connection with housing schemes.

In contrast, the White Paper is content with existing governmental machinery and suggests only the establishment of a small central staff qualified to measure and analyze economic trends and submit their findings and conclusions to the ministry concerned.

The Labor Party.

The White Paper and the Beveridge Report are by no means superseded by the rise to power of the British Labor party. The new Government is indeed proceeding with a limited program of nationalization, including the Bank of England, the coal mines, electrical power production, the railroads, and steel. The nationalization of these industries is being undertaken on grounds of general social policy, and not primarily as a part of a program of full employment.

Nevertheless, the nationalization program *may* have important consequences for full employment. With respect to coal, for example, the National Coal Board which the nationalization bill seeks to establish will be directed "to secure the efficient development of the coal mining industry and make supplies of coal available in quantities and at prices which seem best calculated to further the public interest." This is the crux of the matter.

Ever since World War I, the British coal-mining industry, despite the recommendations of numerous commissions, has not been able to modernize its operations. Costs are high. If modern machinery and large-scale operation under Government ownership can cut the cost of fuel, private consumption and private

[48] Beveridge, *op. cit.*, p. 177.

investment will be stimulated in various directions. The same holds true for electric power and transportation. Increased efficiency and lower costs (if this can be achieved through Government ownership—a matter still to be demonstrated) will help to promote full employment.

Moreover, an expansion of the public sector, as Sir William points out, widens the sphere for public investment, and thus the area in which direct control of capital outlays can be exercised. A "mixed society" affords larger scope for the regularization of investment.[44]

This program is far less revolutionary than is often supposed. The nationalization of the Bank of England has little significance, since for all intents and purposes it has been a Government institution for some decades past. The nationalization of the coal mines has long been under discussion and appears to be the only way out of a long-standing impasse.

Already before the Labor party came into power in 1945, public enterprise played a considerable role. Among these may be listed the Central Electricity Board, the Forestry Commission, the Port of London Authority, the London Passenger Transport Board, and the British Broadcasting Corporation.[45]

[44] For a fuller discussion of the advantages of a "mixed system" both for stabilization and for full employment see Chap. XX, "The Dual Economy," in my *Fiscal Policy and Business Cycles.*

[45] See William A Robson, *Public Enterprise,* George Allen & Unwin, Ltd, London, and T. H. O'Brien, *British Experiments in Public Ownership and Control,* W. W. Norton & Company, Inc., New York.

Chapter VI

Canada

TWO notable documents on full-employment policy were issued by the Canadian Government during the past year—the first, a Paper on Employment and Income presented to Parliament in April, 1945, by the Minister of Reconstruction, and the second, the Dominion-Provincial Conference on Reconstruction in August, 1945.[1]

In the first paper the Government announced its adoption of a high and stable level of employment and income as a major aim of government policy. In thus stating its aim, the government made it emphatically clear that it was "not selecting a lower target than 'full employment.' " The Government was, however, mindful of the difficulties involved, in view of the fluctuations in export trade, seasonal fluctuations, and other factors. To overcome these will require much patient and resourceful work. The Government made it clear that it was "inaugurating policies which break new ground," policies which require full public understanding and support. "In later years, as experience grows, they can be made to yield ever-improving results which will mark a new era in Canadian development." [2]

A Planned Program.

The proposals made by the Government aim at "levels of employment and income greatly above those ruling before the war." This will call for government expenditures at higher than prewar levels.[3] The more important of the positive steps that the Government plans to take include broad policies to stabilize markets and purchasing power through export credits, floor prices, public investment, and extended social services. This program

[1] Both papers are published by Edmund Cloutier, Printer to the King's Most Excellent Majesty, Ottawa.

[2] *Employment and Income*, p. 2.

[3] *Ibid.*, p. 21.

will necessarily involve large expenditures. In periods of declining business activity, it is proposed that these expenditures will be boldly expanded. Tax rates must be reduced at the same time. Large deficits will result. "The Government is not only prepared to accept these but will deliberately plan for them in periods of threatened depression in order to give the economy a stimulus and relieve unemployment." [4]

Government Outlays vs. Government Enterprise.

Government will thus play a larger role in terms of *outlays,* but only to a limited extent in terms of government *enterprise.* "The Government does not believe it to be either desirable or practicable to look to the expansion of Government enterprise to provide, to any large degree, the additional employment required." [5] Rather the Government proposed to use appropriate means to influence all of the various categories of outlays that go to make up aggregate demand—exports, private investment, private consumer expenditure, and public outlays. The endeavor to achieve full employment must pervade all government economic policy. And it must be "wholeheartedly accepted by all economic groups and organizations as a great national objective, transcending in importance all sectional and group interests." [6]

Income Distribution.

The level of private consumption expenditures will depend mainly on the "maintenance and *distribution* of incomes." [7] Benefits paid under social-insurance acts, and payments under the Family Allowance Act of 1944 in respect of children up to sixteen years of age, augment the incomes of families in the lower income groups. Even when financed by a *transfer* of income from higher income groups (with lower marginal propensities to consume) the effect is to increase total consumer outlay. Thus "what is in the first instance a transfer of income will be ultimately paid for, in substantial part, out of an increase in income." [8]

In the Dominion-Provincial Conference, policies were outlined looking toward an increase in consumption. "We must look," the

[4] *Dominion-Provincial Conference,* August, 1945, p 60.
[5] *Employment and Income,* p 5.
[6] *Ibid.,* p. 23.
[7] *Ibid.,* p. 12. Italics are mine.
[8] *Ibid.,* p. 13.

Minister of Justice said, "to a very considerable rise in the general level of consumption. . . . The full realization of these possibilities in advancing the standard of living of every group is the outstanding challenge to our economic system and government policy. . . . The achievement of a greater stability in the flow of consumption expenditures is dependent, to a considerable degree, on the policies that are adopted to protect the basic incomes of the groups whose position is most precarious. The federal government has already taken substantial steps to this end. Unemployment insurance, family allowances, pensions, and other assistance to war veterans, and the policy of farm floor prices are a substantial contribution to social security. They will give strong support to consumption expenditures. . . ." [9]

"A significant volume of social security payments, flowing into the consumer spending stream will stabilize the economy of the country as a whole and work against a fall in the national income. Social security payments therefore become, in these circumstances, a powerful weapon with which to ward off general economic depression." [10]

Already the government has secured the passage in wartime of the Unemployment Insurance Act, the Family Allowances Act, and an act creating the Department of National Health and Welfare.

Public Health.

Health insurance has been under active consideration since the last war. In 1942 the government appointed an Advisory Committee on Health Insurance. This committee made a report in March, 1943, which was widely discussed by interested organizations and individuals. The Canadian Public Health Association, the General Council of the Canadian Medical Association, and numerous farm, labor, and other organizations have passed resolutions approving health insurance.[11] Specific proposals were put forth by the federal government at the Dominion-Provincial Conference, which included: (1) federal grants to the provinces for health planning and organization; (2) federal contributions to

[9] *Dominion-Provincial Conference,* August, 1945, pp. 57-58.
[10] *Ibid.,* p. 85.
[11] *Ibid.,* p. 87.

the cost of benefits (about ⅗ of the total) designed to put the provincial governments in a financial position to develop and administer a comprehensive system of health insurance; (3) federal grants to raise the quality and quantity of public-health services throughout Canada, including a General Public Health Grant, a Tuberculosis Grant, a Mental Health Grant, a Venereal Disease Grant, Crippled Children Grant, a Grant for the Civilian Blind, a Grant for Professional Training, and Public Health Research Grant; and (4) federal assistance in the construction of hospitals.

Social Security.

In the August, 1945, conference, the Government made a new proposal with respect to old-age pensions. The Act of 1937 made old-age pensions available to British subjects who had reached the age of seventy, but payable only in case of need. It was now proposed that the federal government would establish a system of National Old Age Pensions entirely financed by the federal government at the uniform rate of $30 per month regardless of means to men and women aged seventy and over. In addition a Dominion-Provincial Old Age Assistance Plan at age 65 to 69 was proposed, in cases of need, but with changes designed to liberalize the means test.

The Dominion established in 1941 a scheme of unemployment insurance. But the coverage was incomplete and the duration of benefits limited. Accordingly many unemployed persons, unable to qualify or having exhausted their insurance rights, were thrown upon the provincial governments or municipalities for relief. To meet this problem, the Dominion now proposes a comprehensive system of assistance (equal to 85 per cent of insurance benefits) to all able-bodied persons dependent upon employment for their livelihood. In other words, the full responsibility for unemployment relief for employables (after insurance rights had been exhausted) would be carried by the federal government. Local governments would, however, continue to assume responsibility for unemployables. With respect to unemployment insurance, the Dominion Government announced readiness to extend insurance coverage to all employees.

Veterans' Program.

With respect to Veterans' Aid a comprehensive program has been put into effect. This involves *cash grants* (over and above the regular military service pay) including (1) a Basic War Service Gratuity of $7.50 per month plus 25 cents for each day served overseas; (2) a Rehabilitation Grant of one month's pay and a clothing allowance of $100; (3) a Reestablishment Credit (for those who do not avail themselves of vocational or university training or for land settlement) equal in amount to the basic gratuity to assist in the purchase of a business, a home, furniture, tools, or providing for business capital or for government insurance.

In addition there is a *rehabilitation program* providing (1) training in any trade or occupation up to 12 months with allowances while training, (2) university education equal in length to the period of service. Alternatively, there is opportunity for settlement on land with the Government providing an equity up to one-quarter the cost of land and buildings plus an allowance for stock and equipment.

The veteran is allowed out-of-work benefits for one year, medical treatment together with allowances for pensionable disability for life, and veteran life insurance up to $10,000.

Stimulating Investment.

In addition to these measures to stimulate and maintain consumption expenditures, the Government proposes an extensive program to stimulate investment. "A large part of the foundation of an economy of high employment and welfare must be investment. . . . To a very important extent it is by influencing the course of this dynamic force in the future that the Government plans to achieve its employment and welfare objectives." [12]

The Government plans to encourage private investment (1) by taxation reform, (2) by the maintenance of income; (3) by the development of the nation's resources; and (4) by "genuine public investment which will induce more private investment and not supplant it." [13]

[12] *Dominion-Provincial Conference,* August, 1945, p. 76.
[13] *Employment and Income,* p. 16.

Housing.

In the special field of housing, the Government's program aims to assist private enterprise by various measures. The main instrument is the National Housing Act of 1944. It empowers the Government to participate on a comprehensive scale in all phases of a national housing program.[14]

The provincial governments are urged to take necessary steps to ensure that adequate community planning will be carried out. The Dominion is prepared to cooperate in a continuous community-planning program. A community-planning institute for Canada is projected.

In the case of owner occupancy of homes and houses built for ordinary rental purposes, the Dominion will participate by supplying 25 per cent of the loan money at 3 per cent interest and in addition by giving approved lending institutions a partial guarantee against loss. In the case of low-rental housing projects, the Government is prepared to make direct mortgage loans up to 90 per cent of the value at 3 per cent interest. Before such loans are made, the Minister of Finance has to be satisfied that the project area has been adequately planned. Life insurance companies and other financial institutions are encouraged to invest up to 5 per cent of their assets in low- and moderate-rental projects upon which the Government is prepared to guarantee a net return of 2½ per cent per annum.[15]

Under the National Housing Act, the Dominion is prepared to make direct grants to municipalities of half the net cost of slum clearance. Locally organized limited-dividend corporations may obtain from the Government all but a small fraction of the capital needed for building rental projects for low-income groups.

Public Investment.

Note is taken of the limitations that apply to a public investment policy. Public investment cannot alone solve the employment problem. It can only be a part of a broader, integrated program. Public investment must not compete with or replace private investment. Public investment, to be useful and efficiently carried out, must be planned adequately in advance.

[14] *Dominion-Provincial Conference,* p. 65.
[15] *Ibid.,* p. 66.

In the White Paper on Employment and Income, the Government announced its intentions to institute a system of managing its capital expenditures so as to contribute to the improvement and stability of employment and income. It is prepared to press forward as rapidly as possible with a new and forward-looking program for the development and conservation of natural resources. While these expenditures must in part be continuous, a substantial portion may be varied according to employment levels. The Government stated its intention to regulate the timing of its own expenditures and is prepared to secure coordination of provincial and municipal timing of capital outlays. The guiding criterion is to compensate for fluctuations in private investment.[16]

The program of capital outlays includes: (1) conservation and development of mineral, forestry, agricultural, and fishing resources, (2) the improvement of transportation facilities, and (3) the construction of public buildings and equipment required for public services and welfare programs. "Expenditures in these fields ought to be directed to the widening of opportunities so as to create a dependable basis upon which individual initiative can be relied upon to provide rising levels of employment and income. In Canada the possibilities are great." [17]

In this connection note should be taken of the fact that public enterprise plays a large role in Canada. One of the two great railroad systems is government-owned, commercial aviation—Trans-Canada Airways—is a government enterprise, the Bank of Canada is wholly a government institution, the Canadian Broadcasting Corporation is government owned, and hydroelectric power is largely generated and distributed as a government service. This is an old story. Historically, public investment has made a major contribution to Canadian development. "Capitalistic" Canada is already nearly as "socialistic" as Britain will be when the current program of socialization, projected by the Labor Government, is completed!

The Government's proposals with respect to public investment involve: (1) activities for which the Dominion is prepared to assume full responsibility; (2) activities for which the provincial gov-

[16] *Dominion-Provincial Conference,* p. 77.
[17] *Ibid.,* p. 77.

ernments are responsible and which the Dominion is prepared to assist.

The first includes resource development in the Yukon, Northwest Territories, Indian Reserves, and other Dominion-owned lands; basic surveys on a national scale for the conservation, development, and management of national resources; research in resource development; development and conservation of interprovincial resources, including regional watersheds, river-valley systems, etc.; demonstration projects such as soil-erosion control, projects in forest management, and fisheries.

The second includes assistance to raise provincial standards in resource development; assistance for the construction of transportation facilities of national importance, including trans-Canada highways, airports, and railway grade crossings; assistance to promote national programs such as hospital facilities, etc.

The degree to which public investment can be accelerated or postponed depends upon the urgency of the need and the physical nature of the project. "There should be a large volume of truly useful postponable public investment projects of all governments . . . to provide employment when needed."[18] In its own investment policy the Dominion proposed to mitigate or offset deficiencies in *export* income or private-investment outlay by (1) "using public investment programmes to strike as near the source of deficiency as possible; and (2) providing expenditures through established channels in which the deficiencies of income and investment are most severely felt."[19]

The great export industries are agriculture, forestry, and mining. An accelerated resources development and road-development program would provide incomes to these great export groups if exports are low. Increased income for the primary export groups would help the remainder of the economy to maintain consumption and investment outlays.

A decline in private investment releases workers of special skills and reduces the market for certain materials. Public investment in resource development, the construction of public buildings, docks, wharves, and piers would provide employment and mar-

[18] *Ibid.*, p. 81.
[19] *Ibid.*, p. 82.

kets for the labor and materials suffering from a decline in private-investment expenditure.

The Problem of Timing.

In order to induce provincial and municipal governments to cooperate with the Dominion in the development of public investment projects in accordance with over-all employment policy, the Government proposed to offer encouragement to prior *planning* as follows (1) by lending technical and research assistance, (2) by means of Dominion grants covering a part of the cost of planning. Moreover, in order to exercise effective influences on the *timing* of provincial and municipal projects, the Dominion offered to pay a specific grant of a certain per cent of the cost of the project, provided the projects had been previously accepted by the Dominion as fully planned and provided the project was executed in the period designated by the Dominion Authority.

The Budget as a Balance Wheel.

All of these projects, as already noted, would necessarily involve large public expenditures. The government stated that it was prepared to face this situation. "The modern governmental budget must be a balance wheel of the economy; its very size today is such that if it were allowed to fluctuate up and down *with* the rest of the economy instead of deliberately *counter* to the business swings it would so exaggerate booms and depressions as to be disastrous." [20]

The Public Debt.

In the White Paper the Government noted that the national debt had greatly increased during the war. Nevertheless, "the steady reduction in the rate of interest, acquisition of revenue-producing assets, and the rise in the national income have served to keep the cost of carrying the debt down to about the same relative weight it had in 1939. The relative burden after the war is likely to be little more than it was before the war, if income and employment can be maintained at high levels." [21]

This is indeed a noteworthy and remarkable statement. The

[20] *Dominion-Provincial Conference,* p. 60.
[21] *Employment and Income,* p. 21.

point might well have been added that if the "relative burden" is measured, as the statement implies, in terms of debt charges in relation to national income, the "real burden" will in fact prove far less than in 1939. For a rich, high-income nation the disutility of carrying a given *ratio* of debt charges is far less than for a depressed, low-income nation.

In view of the facts recited above, the Government considered the postwar debt problem to be quite manageable. Indeed, the Government announced in a forthright statement that it was prepared "to incur deficits and increases in the national debt resulting from its employment and income policy, whether that policy in the circumstances is best applied through increased expenditure or reduced taxation." [22] It will indeed be the Government's policy to "keep the national debt within manageable proportions." In periods of buoyant employment and income, budget plans will call for surpluses.[22]

Dominion-Provincial Relations.

With respect to Dominion-Provincial financial arrangements, the Government did not believe a return to prewar conditions would enable the Canadian people as a whole to meet their problems. The Government therefore proposed that the provincial governments should by agreement forego the imposition of personal and corporate income tax and succession duties, leaving these revenue sources exclusively to the Dominion. As a condition of such an agreement the Dominion should substantially expand its annual payments to the provincial governments. Moreover, the minimum per capita grant proposed for each province would be raised in proportion to the extent that current Gross National Product exceeded the 1941 level.

Such an arrangement, together with the specific grants-in-aid to various social and welfare services and provincial capital prospects, should enable each province to provide an adequate minimum standard of services for Canadian citizens wherever they might reside. It would, moreover, ensure the provincial governments adequate "financial resources to finance, when necessary, substantial deficits with unquestionable credit." [23]

[22] *Ibid.*, p. 21.
[23] *Dominion-Provincial Conference*, p. 113.

Chapter VII

Australia

IN AUSTRALIA two government documents were issued in 1945 on Full Employment Policy. The first, presented to Parliament in April, was a Report on *Some Problems of Economic Policy* by Professor D. B. Copland, economic consultant to the Prime Minister; the second, presented in May, was a Government Paper on Full Employment in Australia.

The latter document declared that the "policy outlined in this paper is that governments should accept the responsibility for stimulating spending on goods and services to the extent necessary to sustain full employment." The volume of production, it stated, "depends on the demand for goods and services—that is, on expenditure by individuals, firms, public authorities and overseas buyers." [1]

The Importance of Investment.

The Australian Paper stresses the importance of *investment*, public and private, in providing adequate outlays. This, however, does not mean that consumption is regarded as unimportant or incapable of expansion. Rising living standards and a higher level of private consumption and community social services are the aims of all production. But in the short run, the volume of private consumption expenditures is dependent upon incomes and employment. If incomes are stable, "only a change in people's spending habits would change consumption expenditures. These habits change only over a long period." They are indeed to some extent affected by government policy. For example, the provision of social insurance and free community services will permit a higher proportion of total income to be spent in consumption. Moreover, the increase that will accrue to lower income groups,

[1] *Full Employment in Australia*, reprinted in Hearings on Senate 380, Seventy-ninth Congress, 1st Session, Washington, D. C.

as productivity rises, will largely be spent on increased consumption.[2]

But "private consumption expenditure cannot easily be varied to offset temporary fluctuations in other types of spending."[2] Professor Copland puts it as follows: "The level of private consumption is almost a wholly passive component, fluctuating in reference to movements in other components. For any given level of national income it is possible to estimate with a high degree of accuracy the amount that will normally be spent on goods and services by private individuals (private consumption) and the amount that will be saved. There is, however, no guarantee that the amount that will be invested by public and private authorities will be equal to the amount that is saved. If it is less, total national expenditure will fall and employment will decline."[3]

A Minimum Public Investment Program

Public investment, he explains, has always been an important part of total investment. But it should be expanded and it should not be permitted to decline, as in the past, when private investment falls off. Indeed "if private investment is languishing, public investment (public works) should be expanded."[4] Nevertheless, the compensatory program cannot be carried out well without a large *sustained minimum* program of public investment.

Thus the first basic condition for a full-employment program is a "basic minimum level of public investment so that the economy would have the constant stimulus of an element of national expenditure devoted to developmental works and the production of capital goods that private enterprise does not and cannot produce."[5] Outlays above the basic minimum should be made when private investment declined. Public investment "on a growing scale is a basic feature of a modern economy."[6]

A basic minimum program of public investment is essential not only as a continuing and sustaining means of improving the efficiency of the economy and in raising the standard of living, but also as a means of implementing effectively a compensatory program. A basic minimum program of public investment would

[2] *Ibid.*, p. 90.
[3] *Report on Some Problems of Economic Policy*, p 22.
[4] *Ibid.*, p. 29.
[5] *Ibid.*, p. 22.
[6] *Ibid.*, p. 23

require on a continuing basis the administrative and technical organization (architects, engineers, etc.) necessary to plan and execute an expansion beyond the basic minimum whenever it becomes necessary to compensate for a decline in private investment. A compensatory program cannot be improvised at the moment. The "make-work" type of public works can be avoided if the community deliberately plans a basic public investment program.

The Paper on Full Employment stresses the great range and diversity of fields in which public expenditure on capital equipment and development is required all over Australia. It stresses, more than Professor Copland's report, the compensatory possibilities in such a program. "In determining the level of public capital expenditures, account must be taken both of the intrinsic importance of public capital projects for Australia's welfare and development, and of the part which public capital expenditure must play in maintaining full employment. Should a decline in spending threaten to leave resources idle, governments must be prepared to take advantage of the opportunity to employ these resources in accelerating and expanding their own programmes for national works, housing, improvement of capital equipment and provision for facilities for social and cultural activities. Similarly when private capital is tending to expand, some reduction may be made in public capital spending." [7]

Minimum Social-service Standards.

A second basic condition of full employment is a basic minimum proportion of national income devoted to current expenditures on health, education, social services, and national security. "In Australia, a significant contribution to living standards has been made in the past, and will continue to be made, by a high level of social services. Some of these are in the form of direct money payments such as invalid and old-age pensions, child endowment and widows' pensions. Others are services provided directly by governments and public authorities, including education, health and medical services, kindergartens and libraries." [8]

[7] *Full Employment in Australia, op. cit.,* p. 92. See also (p. 97): "It has been established that, since public expenditure in current services is relatively stable except for long-term changes, it is public capital expenditure which must be varied when necessary to maintain full employment."

[8] *Ibid.,* p. 97.

This is intended to ensure a minimum standard of living in all circumstances. "With such an arrangement government expenditure on current services would not decline with a fall in national income and government revenue, as it has in the past." [9]

Stabilizing Private Investment.

In the third place, an effort should be made to stabilize private investment. It is not proposed to give an investment board authority to exercise a rigid control over private investment. But an Advisory National Investment Board representative of government and private enterprise would be desirable as a first step. Moreover, some of the variations in private investment are caused by its "inherent tendency to over-expansion at certain times." [10] A check should be administered through the banking system and the capital market.

The "greatest single contribution to the stability of private capital expenditure will be the assurance that total spending will be maintained at high and stable levels." [11]

Special plans, such as expansion of house building, will, moreover, create new opportunities for private capital expenditure. The policy of low interest rates will be continued, and this also will contribute to expenditures on capital goods. The Industrial Finance Department of the Commonwealth Bank will provide capital finance for small and growing businesses. Finally, the Government will contribute to the expansion of investment opportunities by promoting industrial and agricultural research.

Public Finance and the Public Debt.

There are interesting observations in both these documents with respect to government finance and the public debt. Both documents classify the chief sources of finance as (1) taxation, (2) borrowing through public loans on the market, (3) borrowing from the central bank.

"Taxation should be the main source of revenue. It can be levied so as to secure a more equitable distribution of incomes, and does not create a problem of interest-bearing debt. . . . How-

[9] Copeland Report, *op. cit.,* p. 22.
[10] *Ibid.,* p. 23.
[11] *Full Employment in Australia, op. cit.,* p. 91.

ever, there are limitations on the extent to which taxation can be used. . . ." [12] Taxes should, however, cover expenditures on current items and make some contribution toward public capital expenditures. Besides borrowing from the public, which "avoids some of the disadvantages of taxation," financing by the Commonwealth Bank "can be used to advantage up to the limit of available men and resources, but if carried beyond this point it would gravely threaten the real incomes of workers and low income groups, and would result in conditions so unstable that full employment could not be maintained." [13]

With respect to public investment, Professor Copland's report suggests that the normal financing source would be long-term loans. He suggests, however, that it would be desirable to finance a part from taxation, especially projects associated with education, parks, museums, and some of the health expenditure. "None of these projects readily returns interest directly upon the expenditure, and it would be a prudent measure to rely to some extent on taxation so that the increase in that part of the public debt which could not earn interest would not be too rapid." All projects likely to be self-liquidating could be met by borrowing. The community might of course choose to finance a part of even these outlays from taxation, but such a procedure, Professor Copland believes, would tend to limit the volume of private consumption expenditures. While this might be desirable in the years immediately following the war, in the long run "it would not seem desirable to check the growth of consumption." [14]

Central Bank Financing.

In certain circumstances, funds available in the capital markets might not be adequate to finance the desirable volume of public investment. "This would be the case if private investment were falling and total national income were declining." [15] If tax revenue is falling and the money market is contracting, there is only one source left. The Government "would have to rely on the Central Bank." In the past this has been regarded as an undesirable procedure smacking of inflation. "That is no longer," says Professor

[12] *Full Employment in Australia, op. cit.*, p. 97.
[13] *Ibid.*, p. 97.
[14] Report, *op. cit.*, p. 30.
[15] *Ibid.*, p. 30.

Copland, "a tenable point of view, because direct loans from the Central Bank by way of an expansion of credit would have a desirable influence in two directions. First, it would maintain the volume of employment and total national expenditure by keeping up or even expanding public investment. Secondly, it would automatically contract the tendency toward tightness in the money market. . . . As to the argument that it would cause inflation, it is necessary to distinguish between the effect of expanding credit to keep people in employment . . . and the fear that this practice, once indulged in on a considerable scale, would be resorted to when the volume of employment was already high. It is the fear of the continuance of credit expansion when it is no longer urgently required that has caused it in the past to be regarded as an inflationary device. . . . There will be no need to indulge in such a vigorous credit policy in ordinary times. What is required is that the government and the banking system should be prepared to use credit expansion freely to maintain activity at times when contraction is threatened or is actually in operation." [16]

Non-self-liquidating Projects.

With respect to public capital projects, there is danger that too great stress will be laid on those that are self-liquidating in character. Such a procedure would tend to neglect non-self-liquidating projects of broad community value. Such projects may in appropriate circumstances be loan-financed. "Admittedly this is a doctrine that has its own dangers in practice. . . ." The problem is largely one of efficient administration, and of maintaining an appropriate balance between the amount of non-self-liquidating debt created and the increase in national income.[17]

Professor Copland thinks that in a country like Australia, where public authorities are concerned so much with economic development, a "level of 5 per cent of national income devoted annually to improving the total capital goods owned by the community, apart from expenditures on capital goods out of revenue, could hardly be considered as too much or as economically unsound." [18]

[16] *Ibid.*, p. 30.

[17] *Ibid.*, p. 31. Professor Copland uses the term "non-interest-bearing debt," but it appears clear from the context that he means "non-self-liquidating" debt.

[18] *Ibid.*, p. 22.

Chapter VIII

Sweden

A POSTWAR Economic Planning Commission, with Professor Gunnar Myrdal as chairman, was appointed in February, 1944. It consisted of 21 members, including 11 members of Parliament, representatives of employers' associations and trade unions, chambers of commerce, the cooperative movement, women's organizations, agriculture and exporting industries. The Commission was instructed to draw up the guiding principles of Swedish employment policy after the war.[1]

The work and recommendations of this commission carry forward the now traditional Swedish policy of planning, by various deliberate measures, to maintain high levels of employment and purchasing power. The measures recommended, while novel at some points, are made on the basis of considerable experience with antidepression policy.

A "Mixed" Economy.

The pattern of Swedish employment policy is conditioned to a considerable degree by the structure of the Swedish economy, especially with respect to the relative position of private and public enterprise. The Swedish economy is in large measure a "mixed system," not because of any recent socialization program, but as a result of historical development. Public utilities, telephone, telegraph, and railroads are government enterprises. Other pub-

[1] *Postwar Planning in Sweden.* Studies submitted by the Postwar Planning Commission, and brought up to date by the Swedish Legation in Washington, January, 1945. Extracts from Memorandum of the Commission on Postwar Economic Planning, October, 1944; Summary of Report by Dr. Ingvar Svennilson, Director of the Institute for Industrial Research and Export Adviser to the Commission; Postwar Program of the Swedish Labor Movement; Professor Myrdal on Sweden's Postwar Policies (by Herbert M. Bratter), *The Commercial and Financial Chronicle,* Sept. 13, 1945; "Planning in Sweden," by Axel Iveroth, Secretary, Federation of Swedish Industries, *The Commercial and Financial Chronicle,* Sept. 13, 1945.

lic undertakings include a large part of the forests, the generation and distribution of electric power, and the liquor and tobacco monopolies. Government ownership of these industries constitutes a long-established tradition. It is not the product of a "socialist revolution."

In addition to large government holdings of forest land, the government owns pulp and sawmills in northern Sweden. These were taken over by the government as a consequence of business failures in those industries. The government, moreover, deliberately undertook the construction and operation of new iron works in the far north. This project was started partly to make Sweden less dependent upon imports of commercial iron, and partly to diversify the industry in the region. This development was of course based on the rich iron ore of the region and was moreover facilitated by the abundance of locally generated hydroelectric power.

Some extension of government ownership is currently under discussion in Sweden. The various proposals favored by the social democrats involve the establishment of a State Investment Bank and the socialization of certain industries including the manufacture of some building materials, the shoe and leather industries, and the distribution of gasoline and lubricants. These proposals are still in the controversial stage.

Consumers' Cooperatives.

The Consumers' Cooperative Movement plays an important role and acts as a balancing factor. Private enterprise owns 95 per cent of all manufacturing. Half of the remaining 5 per cent is owned by the government; half by the consumers' cooperatives. The plants owned by cooperatives were acquired in large part as a means of protecting the consumer against monopolistic prices. In addition to this relatively small ownership of manufacturing establishments, the cooperatives conduct about 15 per cent of the total retail trade. The cooperative movement serves to strengthen competition and is accepted by a large part of private enterprise as preferable to antitrust legislation. The cooperatives constitute indeed a significant type of "private enterprise" as opposed to government ownership, and in general the movement is opposed to the extension of government ownership.

Public Enterprise and Public Investment.

The traditional role of public enterprise in the Swedish economy affects employment policy particularly with respect to the place that public investment can play. The Postwar Economic Planning Commission has devoted much attention to this subject. The commission has noted that antidepressional public works often partake of the nature of "relief work." These schemes are usually improvised at the moment, are therefore badly planned, and in general are of small social and economic benefit. The result is a waste of economic resources. A country like Sweden, with large and diversified government-owned undertakings, is in a peculiarly favorable position to implement effectively public investment in its over-all employment program.

The Ministry of Finance has had prepared an inventory, drawn up by the local authorities and by the state-owned enterprises. The "investment reserve" thus compiled, while the equivalent of about two years of normal investment requirements, is to be planned in minute detail so as to be capable of complete utilization, if need be, within one year. The commission emphasized that such a reserve can be used to offset the decline in private building and construction activities during a depression. "Public investment should thus be varied in the opposite direction of private investments." The projects will include, in addition to investment in government enterprises, public works of all kinds, selected with particular attention to the ability of each project to contribute rapidly to an increase in the national income.[2]

Acting under the recommendations of the commission, the task of coordinating public investment of all kinds has been entrusted to a new body—the Public Works Planning Board. State undertakings and local authorities will make regular reports to this board on their investment requirements. In this manner, the public investment reserve can be successively replenished as certain projects are put into operation.

Measures to Stabilize Private Investment.

With respect to private industry, an effort will be made to influence investment so as to eliminate fluctuations as far as pos-

[2] Projects that are not self-liquidating may frequently contribute more to an increase in the national real income than self-liquidating projects.

sible. The possibilities here are much more limited. Indeed, in view of the rapid progress in the technical design of machinery, and to a lesser degree of plant, it is not believed desirable for manufacturing industry to try to anticipate, in time of depression, investment that will be needed later on. There are, however, certain kinds of repair and maintenance work which could be arranged in depression periods. Moreover, office buildings, warehouses, and certain improvements in plants could probably be postponed until depression years.

Private capital expenditures may be coordinated by (1) government incentive measures, and (2) voluntary coordination by industry itself.

A system of direct government contributions or subsidies has already been applied in agriculture and forestry. Consideration has been given to the possibility of varying these contributions according to economic fluctuations. Such measures are not regarded as suitable for other industries.

Incentive taxation has been employed to stabilize investment. Business concerns have been allowed to build up investment funds which are exempted from taxation on the condition that they are used for investment during a depression. As yet this system has not been put to use to any great extent. Consideration will be given to a wider use of this device. The policy might also be applied to maintenance and repairs.

Voluntary coordination has limited possibilities. This should be accomplished through industry's own organizations by furnishing information with respect to the interest of industry itself in investment stabilization, by propaganda, and by personal contacts.

Investment Council.

At the recommendation of the Economic Planning Commission there has recently been set up an Investment Council consisting of representatives of business organizations, labor unions, and government agencies designed to bring about voluntary coordination of private investment with antidepression policy. It will be the job of this council to win voluntary cooperation by furnishing information about over-all employment policy and investment stabilization. Its decisions will not be binding on anybody. Information will also be given with respect to geographical distribu-

tion of new industries. New factories should be steered into areas suffering from a structural decline. Attention should be devoted to the problem of diversification of overly specialized areas. "It is expected that new factories will in the future be attracted to such places as have a surplus of labor." Methods similar to those discussed above with respect to timing could also be applied to influence the geographical distribution of new industries.

Stock-piling.

A special agency has been set up, as suggested by the Economic Planning Commission, to encourage production for stock-piling during a slump. Plans are under way "for stock-piling everything that can be stock-piled without destroying the market." Stock-piling for export trade is especially desirable during the postwar transition until world trade revives.

Stabilization of Urban House Building.

The commission expressed the opinion that a "high degree of building activity will be a *sine qua non* if full employment is to be achieved in Sweden." While using public investment as a countercyclical device, the plans for the construction of urban dwellings do not envisage the expansion or contraction of the residential building industry in accordance with the general employment situation. Instead it is intended to stabilize urban house construction at a steady, high level. The policy is being adopted because it is felt that stabilization of the building industry itself would go far toward stabilizing the economy as a whole. Moreover it is felt that overexpansion of the industry in depression would produce the very distortions in the labor and investment markets which it is intended to avoid. The objective aimed at is 45,000 dwellings per year. Since it is estimated that the present housing shortage will be remedied in about three years, the maintenance of a rate of 45,000 per year will require (1) an increase in the size of apartments from the present average of about three rooms, and (2) the demolition of old buildings at a greatly accelerated rate, by "drastic measures" if necessary.

Stabilization of house construction at a high level is possible in Sweden because the state practically controls the rate of invest-

ment in view of the significant role it plays in financing. While urban residential construction should be stabilized to prevent any serious disorganization of the industry and labor market, house construction in rural areas, it is suggested, might well be expanded during periods of depression.

Subsidizing Consumption.

While planning in Sweden continues to look to public investment as a means to offset fluctuations in private investment and in export trade, less emphasis than formerly is now placed on public works as an antidepression measure. Instead, an effort will be made as far as possible to keep people employed in their regular occupations. The stock-piling device and the stabilization of urban house building, already referred to, would operate in this direction. Moreover, there are plans to promote consumption expenditures as an antidepression policy. The commission considers it irrational to transfer labor from their normal jobs if this can be avoided. A balanced relation between industries should continually be sought. Too great an emphasis on capital outlays, as a measure to combat unemployment, might throw the economic system out of gear. Undue stimulation of private investment by taxation incentives or subsidies might easily have this effect. It would be better, from many points of view, to keep normal production going.

In line with this kind of reasoning, schemes have been proposed in Sweden (as yet undeveloped) to adopt measures to sustain consumption, in combination with other measures to combat unemployment. Plans are being studied, for example, to subsidize consumer purchases of durable goods, such as furniture, refrigerators, electrical apparatus, clothing, etc., which tend to fall off during a depression. In particular it is proposed to grant subsidies to help large families to purchase consumption goods of this character. The food-stamp plan in the thirties, which worked so well in the United States though on far too limited a scale, illustrates the general principle.

Bulk Purchases.

Another proposal, aiming to stimulate consumption, relates to ways and means of increasing the efficiency of the distribution sys-

tem. Thus the economies from large bulk purchases of consumers' goods might be achieved if the state took over the distribution of large quantities of certain kinds of consumers' goods.

Wages and Prices.

With respect to wages and prices, Swedish policy during the period of transition after the war will be directed toward maintaining the level of money incomes, and especially wages, at their wartime level.[3] During the transition period, it is expected that real income will be increased through a gradual fall in the price level. Import prices, which play a major role in the Swedish economy, had risen greatly during the war. A substantial decline in import prices is expected as shipping and world trade are progressively reestablished on a normal basis. Moreover, during the war it became necessary to produce expensive substitutes for goods that could not be imported. Here, also, prices should fall. While the commission places main reliance on free competition and the restoration of world trade to bring these prices down, it proposes that a Price Control Board should be empowered to reduce prices by order if this should prove necessary. The commission was, however, unanimous in the opinion that price controls, and also the rationing of goods, should be dropped as soon as feasible.

Thus it is proposed to restore and improve the prewar standard of living by stabilizing money incomes and effecting a fall in prices as imports and home production rise. This is, to be sure, a short-range policy for the immediate postwar period. Nevertheless, there appears to be a growing disposition in Sweden to accept the view that, also in the long run, improvements in the standard of living can be achieved just as well by a lowering of prices commensurate with increases in productivity as by an increase in money wages. The labor movement is aware that the main basis for increased living standards is an increase in the per capita output of goods and services. Business leaders also are said, in many cases, to have reached the conclusion that a low-price policy, with narrow profit margins—a policy favorable to the general consum-

[3] This would mean that the take-home pay would remain at a high level. Weekly earnings in Sweden were probably not affected so much as in the United States by overtime and extra overtime rates.

ing public—is preferable to high profits, which only become the target for high taxation or higher wages.[4]

For a discussion of my own views of appropriate wage and price policy the reader is referred to Chap. XX in this book.

[4] The Postwar Program of the Swedish Labor Movement stresses very heavily the great importance of a high level of consumption, involving an expansion of community services, higher minimum wages for underprivileged groups, and in general a more equal distribution of income.

Chapter IX

United States: Future Plans

PRESIDENT ROOSEVELT, in his message to Congress on the state of the union in January, 1944, outlined an economic bill of rights. The first among these he stated as follows: "The right of a useful and remunerative job in the industries, or shops, or farms, or mines of the Nation." In his address at Soldiers Field in Chicago, October, 1944, he said: "To assure the full realization of the right to a useful and remunerative employment, an adequate program must provide America with close to 60,000,000 production jobs."

In the Charter of the United Nations, as drafted at San Francisco, full recognition was accorded to the principle that full employment was a necessary basis for the economic and social conditions that provide a favorable climate for peace throughout the world. In the text of the charter, as signed and approved by the United States Senate, the member states commit themselves in Article 55 to "promote higher standards of living, full employment, and conditions of economic and social progress and development."

Employment Act of 1946.

As indicated in previous chapters, a number of governments have made forthright declarations assuming full responsibility for the maintenance of high and stable levels of employment. In the United States, Congress has passed the Employment Act of 1946, which declares that it is the continuing policy and responsibility of the federal government to promote maximum employment, production, and purchasing power.

President Roosevelt on various occasions, of which the citation given above is one, set forth broad objectives of his Administration pointing in this direction. Leaders in the opposition party have expressed similar views. Thus Governor Dewey, Re-

publican candidate for President, in his Seattle speech in September, 1944, said, "If at any time there are not sufficient jobs in private employment to go around, the Government can and must create job opportunities, because there must be jobs for all in this country of ours." But campaign speeches by candidates for office, or even general statements by government officials, do not constitute a formal assumption of governmental responsibility. Under our constitutional system such an assumption of responsibility requires an act of Congress duly signed by the President. The Murray Full Employment bill (S. 380) sought to achieve this end, and the Employment Act of 1946, in rather guarded language, does undertake a federal responsibility for the problem of employment.

It is of course true that the enaction of this bill into law represents only a declaration of policy by the government. Any future Congress could repeal the act and establish a new policy. Nevertheless, as long as this act is on the statute books, the declaration of policy stands, and it may be expected to give direction to governmental policies with respect to stability and full employment.

What Is Meant by "Full Employment."

The Murray bill used the phrase "full employment," but this language is not contained in the Employment Act of 1946. The British White Paper, it will be remembered, used the phrase "high and stable level of employment." There has been considerable discussion in this country about the comparative merits of these terms. I do not think it makes a great deal of difference. Both phrases need definition.[1] It is generally agreed by everyone that in a dynamic society, which needs elbow room in the labor market, it is not possible that the entire labor force shall be continuously employed. In a dynamic market economy, seasonal, transitional, and technological unemployment are inevitably associated with changes in the seasons, the introduction of new products and of new methods of production, the decline of some old industries, and the development and expansion of others. Moreover, in a free society where wage earners work for whom they please, there will of necessity be a degree of labor turnover. Full

[1] For a discussion of my own definition of "full employment" see the footnote on p. 19 of this book.

employment in the United States means perhaps 4 or 5 per cent of the labor force unemployed.

With a postwar labor force of around 60 million, this would mean 2½ to 3 million unemployed on the average during the year. Obviously, the same individuals would not be unemployed all the time. Assuming, on the average, that 5 weeks would elapse before each unemployed person found a new job, a total of 25 to 30 million people would have to shift jobs in each 12-month period if average unemployment were 2½ to 3 million. In other words, 30 million unemployed 5 weeks each year would give us an average unemployment of 3 million. Thus an average of 4 to 5 per cent unemployed would provide enormous flexibility in the labor market.

None of the official declarations on employment policy discussed in previous chapters undertake to guarantee, as is sometimes mistakenly supposed, a job to every individual. Senator Wagner, in opening the hearings on the Murray bill, said: "It is misleading to talk about the full employment bill as a Government commitment to provide jobs for all." What the Employment Act aims to achieve is a condition in which job opportunities are available.

A Planning Act.

The act as finally adopted is essentially a planning measure. It places a specific responsibility upon the President [2] and upon the Congress. It commits the government to a periodical and continuous assessment of the employment situation. The procedures outlined in the Act assure that the government will continually take the pulse and temperature, so to speak, of the economy in order to measure how well its policies are succeeding in achieving one of its primary responsibilities. Thus the elected Govern-

[2] The President, under the terms of the act, will be assisted in the preparation of the Economic Report by a Council of Economic Advisers composed of three members qualified by training and experience to analyze and interpret economic developments and to formulate a national economic policy to promote employment, production, and purchasing power. The Council shall make an Annual Report to the President in December of each year. The Council may employ a staff of specialists, but must to the fullest extent possible utilize the facilities and statistical information of other government agencies and of private research agencies in order to avoid unnecessary duplication.

ment currently responsible for the conduct of national affairs must continually face up with the unemployment problem. The procedures provided in the act would focus the eyes of the nation continuously on goals of economic progress and stability, on rising living standards, and on growth in real national income as rapidly as productivity and high levels of employment permit.

The Economic Report.

The Employment Act of 1946 makes it the duty of the President to transmit to Congress within 60 days after the beginning of each regular session (and thereafter, at his discretion, supplemental reports) an Economic Report setting forth (1) the levels of employment and purchasing power obtaining in the United States, and also the levels needed to create and maintain conditions under which there will be afforded useful employment opportunities for those able, willing, and seeking to work; (2) current and foreseeable trends in the levels of employment, production, and purchasing power; (3) a review of economic conditions affecting employment during the preceding year; and (4) a program for carrying out the policy of the act, together with such recommendations for legislation as he may deem necessary or desirable.

The annual Economic Report, and the supplementary reports, shall be transmitted to Congress and be referred to a Joint Committee on the Economic Report, composed of 7 members from the Senate and 7 from the House. The Joint Committee shall make a continuing study of the matters relating to the Economic Report; and shall file, not later than May 1 of each year, a report with each branch of the Congress containing its findings and recommendations with respect to each of the main recommendations made by the President.

In order to make good on the responsibility assumed under the declared policy of the act, it will be necessary for the President to appraise the various programs and activities of the federal government as they affect income, production, and employment.

The Government's "Tool Chest."

How wide this range of activities can be was ably shown by Harold D. Smith, Director of the Budget, in the statement that

he made in the Hearings before the Full Employment Subcommittee of the Senate Committee in Banking and Currency. He referred to the "tool chest" of government policies. The catalogue of activities of the federal government that directly or indirectly affect employment, production, individual consumption, individual and corporate savings, business investment, housing, foreign trade, capital outlays of state and local governments, etc., as presented is very impressive. It reveals that the federal government has very powerful tools with which it can affect business conditions. "The effect of many of these policies, for good or ill," Mr. Smith said, "is often entirely out of proportion to the direct Federal expenditures involved."

"Fiscal policies have frequently been regarded as the key to a policy of economic stabilization and full employment. As a matter of fact, they are a particularly suitable device because they promptly affect the flow of purchasing power and markets without regimentation of private activities. Yet we have learned that fiscal policies can be made ineffective if other policies discourage business; they can be made most effective if complemented by other policies. The most powerful weapon in the Arsenal of Democracy is coordination of a great variety of policy devices. This bill, as I understand it, does not set up new policy devices or panaceas, but it does set up machinery and procedures for administrative and legislative coordination of all available policies." [3]

In order to ensure that such antidepressional federal expenditure as the President may deem desirable shall be wisely spent, it may be expected that he will include in each Economic Report a statement of plans and preparations made in advance for public-works and public-development projects and other projects and activities including grant-in-aid programs, the initiation of which may appropriately be deferred or advanced according to business conditions. To ensure that there shall always be on hand an adequate file of advance plans and preparations ready to be put into execution when needed, it would be necessary for the President to secure from the Congress advance authorizations for such projects. It would also be necessary to enlist the cooperation of state

[3] *Hearings on Senate* 380, Seventy-ninth Congress, 1st Session, pp. 682-683.

and local governments and private agencies in the timing of any of their activities that may appropriately be deferred or advanced so as to aid in maintaining full employment and economic stability.

The Taft-Radcliffe Amendment.

In the Senate debate on the Murray bill an amendment, proposed by Senators Taft and Radcliffe, was voted which provided that any program of federal investment and expenditure for any year when the nation is at peace shall be accompanied by a program of taxation over a period "comprising the year in question and a reasonable number of years thereafter designed and calculated to prevent during that period any net increase in the national debt (other than debt incurred for self-liquidating projects and other reimbursable expenditures), without interfering with the goal of full employment." This amendment was not included in the Employment Act of 1946, but the Senate debate is of interest since it reflects current trends of thinking in Congress with respect to fiscal matters.

The amendment represents a forward step in the respect that it makes a forthright declaration, formerly never explicitly set forth, of a deliberate policy with respect to fiscal management over the cycle. Until the Roosevelt Administration, at any rate, a failure to balance the budget each year was regarded with suspicion, if indeed not as evidence of fiscal mismanagement. To be sure, despite the policy of annual budget balancing, it has not always been possible in the past to balance the budget each year. In the years of the great depression, though great efforts were made to do so, the Hoover Administration found it in practice impossible to balance the budget.

In the first Roosevelt Budget Message sent to Congress in January, 1934, a "regular" budget was presented which was made to balance by setting up an "extraordinary" budget for emergency expenditures. The President stated that the budget estimates for the fiscal year 1935 show a small surplus, but that this budget "does not include any additional expenditure for extraordinary purposes." The extraordinary budget included the expenditures deemed necessary for relief or recovery. They were not regarded as regular or recurring expenditures. Again in the Budget Mes-

sage of January, 1935, it was pointed out that, for the fiscal year 1934, general receipts approximately equaled the regular expenditures—a "fact which should be duly recognized." Again it was noted that the estimates for the fiscal year 1936 indicated a balance "except for expenditure to give work to the unemployed." In the Budget Message of Jan. 3, 1936, Roosevelt reiterated his distinction between a balanced regular budget and an emergency budget.

In the Budget Message of January, 1938, President Roosevelt divided expenditures into four major types, of varying degrees of flexibility: (1) fixed charges that cannot be reduced by executive action, such as interest on the public debt, pensions, contributions to old-age reserves, etc.; (2) everyday operations of the government that do not afford opportunity for large reductions, such as regular Department salaries and expenditures; (3) relief expenditures of different kinds, including aids to save farms and homes from foreclosure, relief for unemployed, etc.; (4) public capital improvements, new highways, river and harbor projects, etc.

In the January, 1939, Budget Message, the President divided federal expenditures into "ordinary" and "extraordinary." The former relate to the operating expenditures for the normal and continuing functions of government. These, said the President, should be met out of current revenues, and he expressed the hope that in times of prosperity current revenues would so far exceed ordinary expenditures as to produce a "surplus that can be applied against the public debt that the Government must incur in lean years because of extraordinary demands upon it." These extraordinary expenditures he deemed sufficiently flexible in character to permit their contraction and expansion as a partial offset to the rise and fall in the national income. Current revenues would rise and fall *with* the national income and extraordinary expenditures would be adjusted so as to *counteract* these fluctuations. Thus both tax revenues and extraordinary expenditures would be made to serve as a balance wheel to the economy.

It is evident that these Budget Messages were groping toward a reformulation of budgetary principles, partly looking toward a cyclical management of the budget and partly toward the development of a long-run capital budget. But there was never any meeting of minds between the President and Congress. The tradi-

tional principles with respect to budget balancing were never officially abandoned.[4]

The Taft-Radcliffe Amendment to the Murray bill, passed by the Senate on Sept. 28, 1945, may be regarded as the first explicit declaration by at least one branch of Congress of the principle that an unbalanced budget to cope with depression and unemployment is not a violation of *correct* fiscal policy—indeed is a desirable policy. Thus the principle set forth—namely, to accompany any antidepressional program of federal investment and expenditure by a program of taxation designed to cover such expenditure over a "reasonable number of years"—represents a major advance in fiscal thinking in the United States. It represents a complete rejection of the old concept that the federal budget should be balanced every individual year.

What constitutes a reasonable number of years was properly left to be decided, as circumstances might warrant, to the President and the Congress. In discussing the measure, Senator Taft on several occasions made reference, by way of illustration to, say 10 years. "That would be up to the President," he said. "He can pick out any number of years. I suppose that if he said 50 years, Congress might say that would be unreasonable; but I do not know what they could do about it. This leaves it up to the President as to what period he desires to submit." Senator Vandenburg suggested that "the size of the deficit would have some bearing on what was a reasonable number of years," and Senator Taft agreed that "if the deficit were large, it would have to be spread over a longer period." [5]

The bill as passed by the Senate provided, as we have noted, for a program of taxation which should be designed to prevent any net increase in the national debt over a reasonable number

[4] See Alvin H. Hansen, *Fiscal Policy and Business Cycles*, Chap. X

[5] *Congressional Record*, Sept 28, 1945. Note also the following colloquy between Senator Aiken and Senator Taft:

Mr. Aiken: Would not a reasonable number of years be that period of time during which the Government, through taxation or any other method, if there is any other method, could finance the full employment program without increasing the hardship to a greater extent than it would alleviate the distress?

Mr. Taft: I think that is the meaning of it.

Mr. Aiken: No one can foresee how long a period that would be.

Mr. Taft: That is correct. It is left to the President.

of years without interfering with the goal of full employment. It is clear from the Senate debate that there was a difference of opinion as to whether this last phrase constituted a rejection of the idea that even a long-range balance in the federal budget must take precedence over full employment. The phrase "without interfering with the goal of full employment" could be interpreted to mean that indebtedness incurred in a full-employment program should be covered by taxation over a reasonable number of years only in the event that such taxation did not interfere with the goal of full employment. The phrase was in fact so interpreted by Senator Murray and other senators.[6] Senator Murray stated that "the effect of the amendment would not be to require a balancing of the budget if there were an unemployment situation." But Senator Taft thought otherwise. In his view the language used means that the "program of taxation must be one which will not interfere with the goal of full employment." In other words, the *character* of the tax structure should not be such as to interfere with full employment. At another point in the debate, however, Senator Taft seemed to have in mind also the *size* of the tax load. The program of taxation should not call, he said, for taxes so *high* as to interfere with the goal of full employment. "Either the investment and expenditure would have to be reduced or the whole plan would have to be extended over a longer period of years. The important point is that the program must be balanced, without interfering with the goal of full employment."

[6] *Congressional Record*, Sept. 28, 1945.

Mr. Murray: In other words, if at any time there should be a serious period of unemployment, no attempt would be made to balance the budget.

Mr. Taft: No; that is not what the language means. What I have in mind is a program of taxation which is designed and calculated to prevent any net increase in the national debt, but without interfering with the goal of full employment.

Mr. Murray: If there should occur a serious depression which required a heavy program of appropriations, and the budget had not been balanced for some time, would the Senator construe the language of the amendment to mean that in the midst of such a depression we would undertake to balance the budget?

Mr. Taft: No. I have no objection to an unbalanced budget in 1 year or 2 years, but considering the matter over a period, for example, of 10 years, we should be able to tell whether prosperous conditions have returned sufficiently to take care of a deficit in depression years.

Cyclical Compensatory Policy.

A planned program of taxation designed to finance investment and expenditure over a reasonable number of years represents an important forward step compared with traditional public finance procedure in two directions: (1) it provides for the financing of a compensatory fiscal program over the cycle; (2) it provides for long-term financing of public works and capital projects.

Insofar as federal investment and expenditures are used as a balance wheel to offset the larger swings of the business cycle, a reasonable number of years (if we may judge by past experience) lies in the range of 7 to 10 years. Thus 1920 to 1929, a period of 9 years, represented a full swing of the cycle, while the next swing, 1929 to 1937, covered a period of 8 years.

Whenever a decline in income and employment occurs, it is not possible (unless tax rates are raised) to cover the regular, operating expenditures of the government with adequate tax receipts. This follows from the fact that our federal tax system is highly progressive. As is well known, under such a tax system tax revenues fluctuate percentagewise far more than the national income. Moreover, corporate profits fluctuate more than income. and this also results in volatile tax revenues. Thus, with the 1944 tax structure it is estimated that a 10 per cent fall in income would cause about 15 per cent fall in tax receipts. Accordingly, if the tax rates were set sufficiently high for tax receipts to cover the total operating expenditures over an entire cycle, a progressive individual income-tax structure together with a corporate income tax would produce a deficit in low-income years and a surplus in high-income years. It is evident therefore that temporary loan financing in depression years is necessary even in the case of the regular operating expenditures of the government.

Long-term Financing.

Apart from the cycle, the Murray bill as passed by the Senate called for a program of taxation covering investment outlays over a period comprising a reasonable number of years. A program of taxation was not involved, as explicitly stated in the amendment, in the case of long-range financing of self-liquidating projects or other reimbursable expenditures such as loans. All such outlays,

being self-financing in character, needed no *tax*-financing program. Public works and partially self-liquidating capital projects would, however, need a tax-financing program designed, in conformity with the amendment, to cover their cost over a reasonable period. In other words, such projects, in accordance with the provisions of the bill as passed by the Senate, required a tax program adequate (1) to amortize any long-term capital financing over a reasonable period of years and (2) to cover interest on such loans.

What might be a reasonable period would of course vary with the character of each project. An *Account* might be set up for each loan-financed project. Into this Account there would be paid each year an amount of tax money adequate to amortize the project and cover its interest cost. These annual appropriations would become a part of the regular operating expenses of the government and would continue until the loan was finally amortized.

With respect to long-term capital financing of public projects, it would be sound policy for the Treasury to finance the program as far as possible by the sale of savings bonds to the public precisely as was done during the war. No pressure of any kind should be used, but every opportunity should be given to every wage earner, farmer, salaried or professional person to increase his holdings of thrift bonds. In this way a wise use of the public credit could be combined with a sound thrift program.

I have distinguished, in what is said above, between the regular operating expenditures of the government and the long-term financing of capital projects. The regular operating expenses of the government under the terms of the Senate bill, as I read it, were to be balanced over the cycle. The long-term financing projects were to be covered by a program of taxation over a reasonable number of years suitable to each long-term project. In addition, under the terms of the Senate bill self-liquidating projects or other reimbursable expenditures could be loan-financed without involving any tax burden.

Accordingly, the public credit could have been used vigorously (had the Senate measure become law) to prevent the national income and employment from falling below minimum limits set as goals. In the first place, the public credit could be so used within the framework of a cyclically balanced budget. Second, public credit could be so used with respect to public works, and other

capital projects, within the framework of a long-range financing program accompanied by a tax plan designed to cover the cost of such projects within a reasonable number of years. In the third place, the public credit could be used for self-liquidating projects and other reimbursable expenditures.

Fiscal Criteria.

As will be discussed more fully in later chapters, a full-employment program is beset with many difficulties. It would be an easy matter to upset the applecart altogether. A full-employment program requires at one and the same time courage and prudence, it requires bold and vigorous action, at times, coupled with restraint at other times as circumstances require. In such a hitherto uncharted sea, there is no doubt something to be said for tying up to moorings which ensure that one will not float out beyond the sight of familiar land. And there was amply enough of the traditional view of public finance left in the Senate measure to ensure that familiar landscapes would not be lost altogether to view. In time it might become possible, and indeed necessary, to use more rational tests as guides to fiscal policy.

What these more fundamental guideposts should be is discussed more fully elsewhere in this book.[7] Here, however, it may be noted that the Senate debate was struggling with a very real problem. The full implications of the amendment as voted were perhaps not adequately brought out in terms either of a compensatory-cycle program or of long-term capital budgeting. Nevertheless, the senators who sponsored the limiting amendment did set out, though somewhat vaguely, certain practical criteria as guides for fiscal policy. These guides, it is true, will not stand up under a rigorous analysis of rational fiscal policy. But it must be noted that apart from the criteria advanced by the conservatives, there was very little discussion of criteria at all The progressive senators argued for a pragmatic program—in other words, for whatever program of expenditure and taxation might be necessary to promote full employment and stability. To the conservatives, however, that procedure seemed to leave the field wide open without any criteria for policy at all. The criteria for a rational fiscal program were in fact not developed.

[7] See Chaps. IV, V, and XXI.

At one point in the debate Senator Morse came close to a statement of one fundamental criterion for a rational fiscal policy. He said, "When we are ready to grapple with the tax problems of this Congress I shall be perfectly willing to take the position that we must impose taxes sufficiently high to make it possible to protect the value of the American dollar." Here the senator was getting at something very fundamental. Had it been possible to carry this analysis further, including other factors equally pertinent in setting up basic criteria for a tax program, the outcome of the debate would certainly have been different.

Nevertheless, the level on which the debate took place, in contrast with earlier ones, is highly encouraging. And the progress that has already been made in fiscal thinking in this country will not stop where this debate left off. Public discussion and public understanding will grow, particularly under the new experience of financing a large federal budget and managing a large public debt.

It would have been interesting to know how the Senate might have reacted to the following modified version of the amendment: "Provided that any program of Federal investment and expenditure, for the fiscal year 1948 or any subsequent fiscal year when the nation is at peace, shall be accompanied by a program of taxation over a period of years comprising the year in question and a reasonable number of years thereafter designed and calculated to prevent during that period any increase in the *ratio* of interest charges in the national debt to Gross National Product (interest on debt incurred for self-liquidating projects and other reimbursable expenditures not included), without interfering with the goal of full employment."

An amendment of this character would be in keeping with Professor Copland's statement, referred to in Chap. VII, namely, that the problem is largely one of efficient administration and of maintaining an appropriate balance between (1) the amount of non self-liquidating debt created and (2) the increase in national income. Such a balance would permit the growing debt charges to be paid, as Professor Copland says, out of the increase in revenue springing from the growth in national income as the general level of productivity of the community is increased without resort to increase in tax rates.

The debate clearly reveals that senators were concerned over the danger that future taxes, designed to repay loans that had financed antidepressional expenditures, might unfavorably affect future employment conditions. The situation is analogous to that of stimulating exports by means of current foreign loans, the repayment of which in the future is likely to create a difficult "balance of payments" problem. If the country in future years is fortunate enough to be highly prosperous, it will likely be able to import enough to take repayment on past loans without difficulty. Similarly, if in the future private investment opportunities should prove sufficiently attractive to provide investment outlets for all current private savings and in addition absorb the funds paid back into the capital markets through the repayment of government loans, all would be well. But this may not prove to be the case. Repayment of government loans, like private amortization of debt, adds to the total flow of savings. Whether the repayment of loans is in fact feasible without interfering with full employment is a part of the larger problem of continually finding adequate outlets for the savings generated by (1) the amortization of past debt, public and private, (2) depreciation reserves, (3) net corporate savings and (4) savings of individuals from current income. This is the basic problem. Government loans made today ease today's savings-investment problem; but if repaid tomorrow, tomorrow's problem is intensified.

Thus there was good reason for the senators most concerned about full employment to be wary of introducing a limiting amendment which might build up trouble for the future. Yet the Senate as a whole was fearful of an "uncharted sea" with no moorings to tie to. They wanted to see their way out. Accordingly, they voted for repayment "over a reasonable number of years." A better solution, which might indeed have satisfied the majority, would have been an amendment providing for a program of taxation adequate to ensure that the debt charges, taking a reasonable number of years into account, should not rise in relation to the Gross National Product. This rule might indeed impose a rigidity which would violate the basic and fundamental criteria for fiscal policy. But in practice it probably provides adequate leeway within which a rational fiscal program could be pursued. Such knowledge as we now have about the problem

indicates that we could satisfy all the requirements of stability, full employment, social priorities, and optimum distribution of income without any rise in debt charges in relation to Gross National Product.

None of these considerations are encountered in the Employment Act of 1946 as passed by both houses of Congress and signed by the President. The Employment Act as passed makes no attempt (I think wisely) to settle any matter of policy with respect to taxation, expenditure, or borrowing, or indeed any other governmental measures. It merely affirms responsibility and sets up a procedure by which the President and the Congress will face at the beginning of each session the over-all program of the federal government with respect to ways and means of promoting a high level of employment and production.

Chapter X

United States: Progress to Date

HAVE we made any progress toward the solution of the basic problem of economic instability and mass unemployment? Is there a prospect that changed conditions, whether contrived or accidental, will produce better results than those experienced in the interwar decades?

In the United Kingdom, unemployment ranged from 10 per cent to 22 per cent in the interwar years. The average rate was 21 3 per cent in 1931-1933, and in the relatively good years 1935-1938 it was 13.1 per cent. At the outbreak of the war in 1939 unemployment was still 10.3 per cent [1]

In the United States unemployment averaged 11,800,000 in 1931-1933, or 23.8 per cent of the total labor force. In 1936-1939 the average was 8,600,000, or 16.3 per cent of the total labor force. In 1940 unemployment was still 7,500,000, or 13.8 per cent.[2] Employment had indeed increased by 9.2 million from the bottom of the depression to 1940. But in the meantime the labor force had increased by nearly 600,000 per year.

In opening the hearings on the Full Employment bill Senator Wagner said: "The size of the task before us, the great human issues involved, require complete candor in our examination of past experience. During the decade before the war, we in this country wrestled continuously with the problems of mass unemployment. Substantial gains were made toward reducing its volume. Even more substantial gains were made toward humanizing the methods of dealing with its victims. I do not need to catalog here that record of progress—through improved banking and security exchange legislation, through social security, through re-

[1] Sir William Beveridge, *Full Employment in a Free Society*, p. 47.

[2] SOURCE: Department of Commerce, Bureau of the Census, Department of Labor, Bureau of Labor Statistics; *Basic Facts on Employment and Production*, Senate Committee Print No 4, 79th Congress, 1st Session.

forms in private home financing, through slum clearance, public housing and public works. But no one can pretend that these measures alone, or even in combination, solved the problem to our satisfaction. . . . No thinking person can fail to shrink from the results that would follow if we do not better this record in the future." [3]

New-deal Reforms.

A number of the measures listed by Senator Wagner had barely begun to play any considerable role when the war came upon us. This is true of the housing program and even of social security. Some measures, such as the salvaging of home mortgages, relief, and public works, had alleviated serious distress during the depression. Others represented important institutional reforms aimed at the prevention in the future of such excesses as the irresponsible financing of mortgages, the flotation of ill-advised securities, and the stock-market speculation of the twenties.

Looking toward the postwar period, we shall be confronted, no doubt, with new situations for which we are wholly or partly unprepared. There is some truth, probably, in the assertion that in economic no less than in military matters "we are always fighting the last war." Nevertheless, there is reason to believe that some progress has been made. We are, I believe, better prepared, at least in outlook and thinking, to face the next depression. It is true that we have only made a beginning either in the implementation of an antidepression program or in the development of a sustained program for expansion and full employment. Yet there are favorable factors compared with the interwar years. These factors are partly of an accidental character and partly the result of deliberate policy.

The structural reforms directed toward remedying or reducing the distortions and maladjustments of a boom such as that of 1928-1929 are of great importance. They relate mainly to finance.

The new system of home-mortgage financing established under the Federal Housing Administration represents a major improvement in a situation that was deplorably chaotic and unsound. Not only was there a wide differential in the interest rate on first mortgages in various parts of the United States, but in addition,

[3] Hearings, Senate Subcommittee on S. 380, 79th Congress, 1st Session.

in many sections of the country, second and third mortgages, with exorbitant and even usurious rates, were piled on top. Frequently the average rate, first, second, and third mortgages combined, was such that default by the borrower might almost be said to be invited and, in fact, was often rendered inevitable. Provision for amortization of the loan was typically missing or at any rate wholly inadequate. Loans were made with inadequate appraisal of the burden undertaken by the borrower in relation to his capacity to pay. No adequate standards were enforced by the mortgage lenders on the quality and soundness of construction.

The Federal Housing Administration has brought order and common sense into the home-mortgage field and has lifted the standards of the urban mortgage market, affording protection both to the borrower and to the lender. The system of mutual mortgage insurance backed by the final guarantee of the United States Treasury, together with the safeguards it has introduced, has at long last given the country a reasonably low rate of interest and a mortgage system that contributes to financial stability in home ownership. We must be on our guard not to allow new excesses In particular the lending provisions of the GI Bill of Rights need to be integrated with the rest of the housing program and safeguarded against abuses.

Many international loans in the speculative twenties were notoriously unsound and irresponsible. They contributed to the debacle, and especially to the international monetary and financial breakdown. The Export-Import Bank and the International Bank for Reconstruction and Development give promise that greater caution will be exercised in the future with respect to international lending. Loans made under the auspices of these institutions will be on specific projects that contribute to the productivity and welfare of the country. Commission charges and rates of interest will be reasonable. The standards thus established can scarcely fail also to influence the character and soundness of privately arranged international loans and investments.

Boom Distortions.

These developments, together with the insurance of deposits under the Federal Deposit Insurance Corporation and other banking reforms, the establishment of the Securities and Exchange

Commission, the control over stock-market speculation (margin requirements, etc.) and other regulations of the stock market—all point, we may hope, toward less dangerous financial storms, with less havoc following in their wake, in future periods of high prosperity. Many of the excesses of past booms are not inevitable or necessary characteristics of high levels of private investment. They are evils that can more or less be eradicated, and to this end we have made at least a beginning.

All this is important for the problem of maintaining full employment. It is not true, as formerly held by many, and even now occasionally by some, that only a severe depression can "purge" the social structure from periodically accumulating diseases that manifest themselves in a boom. But it *is* true that the forces making for a cumulative deflation and depression will be far less powerful and will render the execution of effective measures to sustain employment and production less difficult, if excesses and distortions are not permitted to develop in periods of high investment activity. Fundamental structural reforms can eliminate many of these distortions and abuses. Such reforms are an important part of a full-employment program. And this is a continuing job, since new unsound practices are always cropping up. The regulatory role of government is of primary importance in the maintenance of a well-functioning market economy.

This is the "negative" or "protective" part of the picture. On the "positive" or "promotive" side there are also encouraging factors, partly accidental and partly the result of deliberate policy.

A High Propensity to Consume.

Consider the propensity to consume in the United States. Are we gradually achieving a high-consumption economy in this country? Or at any rate are we making progress relative to the thirties?

With respect to our social-security program, the answer is, I think, a qualified Yes. Social insurance, it is true, from the time it was introduced in 1935, was mainly a system of compulsory social saving. That this is so is shown by the fact that reserves had been built up in the old-age and unemployment-insurance trust funds amounting together by November, 1945, to 14.7 billion dollars. Far more money had been abstracted from the income stream through pay-roll taxes than had been injected into

it through the payment of insurance benefits. The net effect was deflationary. The annual net addition to the reserve funds augmented the flow of current savings. Additional outlays, whether private investment or governmental loan expenditures, were necessary in order to offset these savings over and above what would otherwise have been necessary to maintain income and employment.

At the inception of the program a highly conservative method of financing was probably inevitable and necessary. Social insurance was a new venture for the United States. It was widely regarded with suspicion and as financially unworkable. The only comparable thing with which Americans were familiar was private life insurance. Life insurance, privately financed, required the accumulation of a reserve during the lifetime of the insured person. How else would the beneficiary be paid? The early history of life insurance, especially that of fraternal organizations, had made Americans wary of any system that was not built on rigorously sound financial lines. Moreover, there was much discussion, often misinformed, about the "bankruptcy" of social-insurance systems in foreign countries. In all probability social insurance could not have gotten a firm foothold in the United States without a program of "sound financing." And that, to the average American, meant that there must be "money in the bank" to ensure the payment of benefits. Had either the old-age or unemployment-insurance systems failed to show a substantial surplus in the early years of their experience, it is questionable whether the legislation could have survived the attacks that would have been made upon it.

Thus the deflationary effect of the social-insurance financing was probably the price that had to be paid for "getting off on a good start." In the meantime, social insurance has taken firm root. It is no longer in danger. It has become a fixed part of our social structure.

Increasingly discussion shifted toward appropriate methods of financing. Oddly enough, criticism of the reserves in part came from highly conservative quarters—criticism based on the fantastic notion that the reserve was a fraud perpetrated on the public. It was asserted that in fact no true reserve was being built up because the old-age account was accumulating no "money," but

instead was using money obtained from pay-roll taxes to buy government bonds. The Treasury in turn was spending all the money thus received for relief, public works, and other government expenditures. Hence, it was said, there was nothing to show for the hard-earned money collected from workers and employers to finance old-age insurance. The same argument was applied to the unemployment trust fund.

That this argument could seriously have been advanced in newspaper editorials and elsewhere is truly incredible. And on occasion it is still encountered. The reasoning is based on the primitive notion that savings must take the form of "hoards" of some kind (gold or currency, for example). Modern savings are typically invested in securities, public or private. The investment of reserve funds in federal government bonds is in no way different from similar investments made by private financial institutions.

A different argument was to the effect that the insurance reserve funds supplied a ready market for Treasury issues, and this might encourage wasteful government spending. The notion that any modern government could face financing difficulties, equipped as it is with vast taxable capacity and having available a great capital market (supported when needed by the Federal Reserve System), is utterly untenable. If there were any lingering doubts about this, they have surely been dispelled by the war-financing experience of this and every other advanced democracy.

A still different version ran to the effect that the reserves, being invested in bonds upon which the government had to pay interest, were really a clumsy and expensive device to obtain a contribution from the federal government. Instead of paying the government vast sums of money (derived from pay-roll taxes) in exchange for bonds which obligated the Treasury to make annual contributions (interest payments) to the social-insurance systems, why not pass a law obligating the Treasury to make such annual contribution in the first place without "buying" the privilege, so to speak, through the purchase of special issues? This plan, it was said, would cost the Treasury no more money than the accumulated-reserve plan, and it would save the workers and employers from paying excess pay-roll taxes. In other words, the contribution by the Treasury could just as well be made without going

through the roundabout process of building up a reserve. The Treasury would then have to rely exclusively upon the regular capital markets or the banking system in its financing operations.

The opposition to the alleged hocus-pocus of social-insurance reserve funds, while confused and often fallacious, nevertheless played a part, no doubt, in the growing resistance to building up a gigantic reserve. Doubtless the most powerful drive back of this growing resistance was the desire, especially on the part of employers, to avoid the scheduled increases in pay-roll taxes. This practical consideration would hardly have prevented the increases, however, were it not for the growing agreement in government, business, and labor circles that the building up of large reserves was seriously deflationary and could not be justified on rational fiscal grounds. Accordingly, taking all factors into account, the scheduled increases have consistently been turned down in Congress.

During the war period it would, to be sure, have been in accord with the principles of compensatory fiscal policy to have stepped up the pay-roll taxes as an anti-inflationary measure as urged by the President. Congress, however, refused to go along, and I think rightly so, since there was no good reason for mixing the management of social insurance with war financing. An adequate program of anti-inflationary taxation could be imposed without any change in the social-security taxes.

Under the provisions of the original Old Age Reserve plan it was estimated that a reserve of 47 billion dollars would be accumulated by 1980. This program was abandoned in 1939, and, as we have noted, the scheduled increases in pay-roll taxes have not been made. Even so, the revenues have greatly exceeded the benefit payments up to date. The Wagner Social Security bill, introduced in 1944, called for total pay-roll taxes of 12 per cent; this would have involved the accumulation of a large reserve. The pay-roll tax schedule was, however, reduced in a later version of the bill to 8 per cent. Taking account of the great extension in benefit payments proposed in the bill, income and outgo would approximately balance. If adopted, this would mean that the growth in benefit payments as the program approached maturity would in part have to be borne by the Treasury, financed from the general tax revenues. This would be a step in the right direction.

It is of major importance to remove deflationary financing from the social-security program. This reform would help to raise the consumption function in two ways—one, by stopping the deflationary effect of the excess of pay-roll taxes over benefit payments, and second, by a gradual shift over to partial financing from progressive income taxation.

Equally important for income distribution and a high propensity to consume is the shift (which war financing has brought, with prospects for a substantial carry-over to peacetime) toward a more progressive tax structure than that of the prewar period.

Is there any prospect that we are on our way to a high-wage, low-profit economy? In the thirties realized profits were indeed relatively low. But profits in relation to sales volume in the late thirties were high. The "break-even point" for many industries was reached at low-capacity utilization. We shall not likely again tolerate so high a degree of unused capacity.

At a higher level of output, the *share* of the total product paid in wages can be increased. And with the current widespread unionization of mass-production industries (one of the major structural changes of the late thirties), this result may not unlikely be achieved. Moreover, the general nation-wide leveling upward of low-standard wages, through federal minimum-wage legislation, was just beginning to take effect upon the outbreak of war in Europe. During the war there was further upward pressure through the wage-adjustment program. The President's current proposal to raise the minimum to 65 cents per hour is vigorously resisted, and it is not yet clear how far, especially in view of the great power of Southern conservatives in the Democratic party, the leveling upward of low-standard wages can be carried out.

In two other directions the prospects for a high-consumption function rest on fairly substantial grounds. The agricultural program, while still undergoing change and experimentation, has reached a place no less secure in our social structure than that of social security. American farmers are not now, as after World War I, confronted with a wholly unsupported market, nor do they face the prospect of a shrinkage of net farm income of such proportions as that from 1929 to 1932. The farm program is sufficiently well in hand to prevent such a collapse. We are no longer hopelessly at sea about what to do. Income supplements may come

to play a larger role as time goes on, with less emphasis on price supports. But whatever the method, farm purchasing power, there is reason to believe, will be reasonably well maintained. As with social security, the farm program affects the distribution of the national income in a direction favorable to the maintenance of high consumption.

Another factor, whose net effect on consumption is not easy to appraise, is the large volume of liquid assets now held by the American community. First, there is the question to what extent these holdings will still be intact after the reconversion has been completed and the wartime scarcities have been fully overcome. Should these savings in fact be dissipated in a spending spree during the postwar restocking period, all the potential benefits of the wartime accumulated savings would be lost for the postwar economy. This, however, can certainly be avoided unless we abandon the necessary controls too early; that is, before peacetime supplies catch up with demand. If appropriate public policies are adopted, sample studies [4] indicate that the people can be relied upon to act in a sensible manner with respect to their savings.

These liquid assets (cash and securities) have been accumulated as a by-product of the war. But they are not a mere accident. They are to be credited to the sound common sense of the population generally in the management of their wartime incomes. Unable to spend money on consumers' durables (automobiles, refrigerators, etc.) or to invest it in new houses, many succeeded in saving their excess incomes. To be sure, this purpose would have been defeated had not mass purchasing been restrained by price control and rationing. Without these measures, the price line would have been broken, thereby defeating the self-restraint of those who were trying to save. A by-product of the war, the wartime savings accumulations could not have been won except for the creditable record of achievement in the execution and enforcement of control measures, backed up by a reasonable restraint on individual spending.

[4] See the studies made by the Bureau of Agricultural Economics, Department of Agriculture, at the request of the Board of Governors of the Federal Reserve System, in Alabama and Illinois, published in the *Federal Reserve Bulletin,* November, 1945, also *Fortune,* November, 1945.

But here I wish to register a caution. We do not yet know what the net effect of this whole experience will turn out to be on the postwar propensity to consume or conversely the propensity to save. On the one side, the sense of security afforded by a nest egg of savings would tend to raise the propensity to spend on consumers' goods. If one feels that the future is relatively secure, one does not hesitate to spend. On the other hand, the wartime habit of saving may be projected into the peacetime period, the more so since incomes have suddenly risen to a new high level within so short a time that consumption standards have not yet caught up. What the net effect will be is not easy to say. Moreover, it must not be forgotten that the vast majority hold a relatively small part of the total. In the small samples studied by the Department of Agriculture, it was found that those with incomes under $55 per week (about $2,750 per year) held only 23 per cent of the assets. Moreover, it is highly significant that the savings are not all equally distributed among the members of any income class. Indeed, *one-third* of those earning less than $55 per week owned 78 per cent of all the assets held by this income group, the remaining two-thirds having accumulated relatively little savings. The same held true for the upper income class (those earning over $55 per week). For this group also the distribution of holdings is highly concentrated, one-third holding 77 per cent of the total assets held by this entire income group. Thus a large proportion of the population has not succeeded in saving any appreciable amount. This fact is highly significant and must affect very much one's appraisal of the influence of these liquid-asset holdings on the postwar propensity to consume.

A still more recent analysis reveals that those with incomes under $2,000 per year (47 per cent of all spending units) held 21 per cent of the liquid assets, while those with incomes over $4,000 (15 per cent of all spending units) held 46 per cent of the liquid assets.[5]

A Low Rate of Interest.

Another favorable factor for postwar employment is the achievement of a low rate of interest. We do not yet know how important this may turn out to be. The interest yield on "triple A"

[5] See *Federal Reserve Bulletin,* July, 1946.

corporate bonds was 6.0 per cent in 1921, 4.7 per cent in 1929, 4.0 per cent in 1934, 3.2 per cent in 1938, 2 8 per cent in 1940, and 2.6 per cent in 1945. But the different compartments of the money and capital market are not in a perfectly "fluid" relation to each other. It requires deliberate implementation to force the rate in different areas of the structure into line with the gilt-edged market rate. Thus it was not until the device of mutual mortgage insurance with United States Treasury guarantee under the FHA that cheap money became effective in home financing. The time has now come to push the urban mortgage rate still lower. Under the proposed Wagner-Ellender-Taft bill the maximum rate is cut to 4 per cent,[6] which in fact reflects pretty much the current market. With interest on long-term federal bonds below 2 per cent, and considering the Treasury guarantee on FHA mortgages, there is no good reason why the rate should not be reduced to 3½ per cent. Housing is not only the most important field for private investment; it is also the area in which a low rate of interest is most effective.

Government lending and guarantee agencies have made only a beginning in the implementation of low rates of interest in various areas affecting private investment. The scope and ramifying influence of government credit and lending agencies may be indicated by a mere enumeration: banks for cooperatives, federal intermediate credit banks, federal land banks, production credit corporations, Rural Electrification Administration, Commodity Credit Corporation, Farm Security Administration, Federal Crop Insurance Corporation, Federal Surplus Commodities Corporation, Federal Home Loan Banks, Federal Savings and Loan Insurance Corporation, Home Owners Loan Corporation, Federal Housing Administration, Federal National Mortgage Association, RFC Mortgage Company, Reconstruction Finance Corporation, Export-Import Bank, Smaller War Plants Corporation, Federal Deposit Insurance Corporation, Federal Reserve System.

In general a low rate of interest throughout the whole economy helps to promote a high-wage, low-profit system. A low rate of interest tends toward a more equal distribution of income and a higher consumption economy. Thus a low rate of interest is not

[6] The maximum under the first legislation was 5 per cent, and this was subsequently reduced to 4½ per cent.

only a stimulus to outlays on new investment (especially housing) but it is also a stimulus to consumption.

A Large Federal Budget.

Finally, a factor that makes the postwar prospects definitely more favorable than the prewar record is the revolution that has occurred in the size of the federal budget. A federal postwar budget around 25 to 30 billion dollars is now generally accepted. In the prewar period 1936-1940, the average federal budget was 8.5 billion dollars.[7] The expansionist effect of so large an increase in the federal budget alone makes the postwar picture very different from that of the prewar. This is one of the major gains from the war experience. As analyzed in Chap. IV, aggregate demand in the prewar period was not commensurate with our productive capacity, and one reason for this was the lagging adjustment of public outlays as a factor in the general advance in living standards. An aggregate demand adequate to purchase the output of goods and services made possible by modern technology required a major expansion in the public outlay sector.

Instability an Obstacle to Low-price Policy

One serious difficulty still confronts us. Until it has been demonstrated that stability and full employment can be maintained within reasonably satisfactory limits, it will not be possible for business to practice a fully effective low-price, high-wage policy. So long as businessmen expect large fluctuations in the volume of sales and in prices, they *must* price their products above the "equilibrium" price in periods of good times. If they did not do so, they could not make excess profits, in periods of high sales volume, sufficient to cover losses in depression periods. Thus a vicious circle is set up. Excessive profits in periods of high employment are rendered necessary by the fact of instability, yet

[7] In 1925-1929, publicly financed construction averaged 2.3 billion dollars per year, while privately financed construction averaged 8.6 billion dollars. In the postwar period around 5 billion dollars of public construction, federal, state, and local, or more than twice the prewar, was envisaged by General Fleming, Administrator, Federal Works Agency, in his testimony before the Full Employment Subcommittee. This refers to *new* construction, not including repairs and maintenance construction. See Hearings on S. 380, 79th Congress, 1st Session, p. 864.

their existence inevitably brings on the very depression the losses of which they are designed to cover. This is true, because the very process of investment of high-prosperity profits leads sooner or later to a *saturation* of investment. Thus the boom dies, as Professor Hicks has so well said, a natural death. In other words, the savings-investment problem is intensified by the fact that past and prospective instability induces a high pricing policy that leads to excessive profits whenever employment and sales are high. Accordingly, an extra heavy load is placed upon offsetting or corrective policies, whether direct loan expenditures of the government or long-run measures to raise the consumption function and to enlarge the outlets for private investment, etc. In particular the task confronting fiscal policy will remain heavier than it need be until the vicious circle is broken But it cannot be broken except by applying fiscal policy and other measures continuously and adequately long enough to remove the *expectation* of instability.

The Long-run Prospect.

Gradual adjustment to a better balance can be achieved, if policies appropriate to the needs of the modern economy are actively pursued. For one thing, an expanded social-security program, together with a continued growth in the mass ownership of liquid assets,[8] will progressively raise the propensity to consume Achieved success in a full-employment program will increasingly promote a better distribution of income by making it at long last possible to introduce a low-price, high-wage policy commensurate with the requirement of an "equilibrium" profit rate at the full-employment level of production. As yet we have relatively little knowledge of or experience with the kind of tax structure that can best promote a long-term equilibrium in income distribution and so achieve an appropriate balance between consumption and investment at high levels of employment. Finally, we are moving more and more into a dual economy in which the state plays an important role in the process of income creation—through its capacity as provider of community services; through public investment in public facilities and the improvement and development of natural resources; through those many monetary and fiscal ac-

[8] What this means with respect to taxation and the increase in the public debt is discussed in Chap. XXII.

tivities (lending operations, management of the public debt, fiscal operations including taxation and borrowing, control of the rate of interest and of the money supply) that influence indirectly the rate of private expenditures in a market economy; and last but not least, through the maintenance of a well-functioning price system involving wage and price adjustments consistent with the requirements of increasing productivity and technological change.

PART FOUR

BASIC POLICIES FOR FULL EMPLOYMENT

Chapter XI

Tax Policy

SO LONG as public expenditures were comparatively small, it was necessary to emphasize larger outlays, and to use variation in the rate of expenditure as a balance wheel for the economy as a whole. The prospective growth in the federal postwar budget relative to prewar makes it now possible to lay more stress than formerly upon variations in tax rates and upon the tax structure as a means of controlling fluctuations and stabilizing employment at a high level.

The Tax Structure.

In an able statement, in the hearings on the Full Employment bill, Mr. Harold Smith, Director of the Budget, said:

"Taxation, borrowing, and debt management have become decisive factors influencing business activities. When the Federal Budget was small, we were mainly concerned with considerations of equity and administrative convenience in the selection of financial sources for covering expenditures. The way in which we finance a 25-billion dollar budget will inevitably affect the economy as a whole. To illustrate this point by extreme cases, we can be sure that there will be inflation if the Federal Government finances all its expenditures by borrowing. If, on the other hand, the Federal Government attempts to finance all expenditures by a general sales tax which restricts individual purchases more than an other tax, I am confident we should have deflation and unemployment." [1]

It has often been suggested that publicly provided services of all kinds should be paid by those who use them just as privately provided goods and services are purchased over the counter. If this were done, the fiscal management of the public sector in the economy would make no special contribution to securing adequate

[1] Hearings on S 380, 79th Congress, 1st Session, p. 682.

aggregate demand over and above a condition in which all goods and services were privately produced and sold at a uniform price. The expansionist effect of financing outlays from progressive taxation and still more from borrowing would then not be available as means of enlarging aggregate demand.

If consumers paid for public services precisely as they do for privately provided goods and services, this would mean the complete elimination of progressive income taxation. It would even have a more regressive influence on income distribution than a strictly proportional income tax. If publicly supplied services were paid for on the price basis, taxes would be *proportional to consumption.* Thus the rich and well-to-do who save a large part of their incomes would pay even less taxes than if a directly proportional income tax were applied.

If we financed our large postwar federal budget in this manner, there are probably few students of public finance who would doubt that aggregate demand would be inadequate. On the other hand, if we financed it all from borrowing, we should certainly generate so large an aggregate demand as to produce an inflation.

Accordingly, we need to find a middle course. In part this involves progressive income taxation, with the rate structure sufficiently low to permit an adequate volume of private expenditures and investment outlays. Public expenditures should be adequate to satisfy urgent social needs on the basis of social priorities. Taking account of these public outlays some borrowing may be necessary to ensure adequate aggregate demand in view of the prevailing propensity to consume and the inducement to invest.

Controlled Borrowing.

In the event that some borrowing is called for, this is surely to be preferred to unemployment and low business activity. Nor is it an unmixed evil on its own account. A moderate rise in the public debt need not involve an increase in *tax rates* to finance the growing service charges; for in a growing dynamic country the Gross National Product can be expected to rise. In the United States it has doubled approximately every 20 years.[2] Moreover, within the limits imposed by a rational fiscal policy (of which preservation of the value of money is a cardinal principle) it is

[2] Louis Bean, *Review of Economic Statistics,* November, 1945.

not sound policy to tax the public excessively. And taxes are excessive if aggregate demand is not sufficient to provide full employment.[3] Borrowing permits the public to add to their holdings of liquid assets—deposits and securities. These assets are eagerly desired by everyone. They provide a sense of security and so promote a higher level of consumer spending out of current income. If these liquid assets tend to become too large, taxes should be raised in order to prevent inflation.

Millions of Americans feel more secure today by reason of these accumulated savings. These savings could for the most part not have been achieved had we wholly tax-financed the war. How far the war expenditures should have been tax-financed is of course a matter of judgment and balance. I myself advocated a heavier burden of taxes during the war than was in fact levied. We have *suddenly* grown into a volume of liquid assets so large as to require careful management in view of the special conditions of the first postwar years. But that is now water over the dam. The liquid assets are here. We have preserved them thus far by keeping spending down during the period of war-created scarcities. And we must now strive with might and main to preserve them during the reconversion period until we are over the hump Once the full stream of production in all lines becomes available and war-created scarcities are overcome, our accumulated savings will not prove excessive. After we have gotten over the period of temporary scarcities and are again confronted with a "buyers' market," these liquid assets will stand us in good stead.

It is in fact by now widely recognized that reduction of the public debt in any volume is not possible and would indeed be disastrous. The widespread benefits to individuals, to business, and to the community as a whole from the accumulated wartime savings is generally appreciated. The large holdings by commercial banks is indeed a special problem, and this matter is fully discussed in Chaps. XVII and XXI.

There are indeed rational grounds for the policy of financing the great bulk of public expenditures from taxation. But it is nonetheless important to see clearly that it is not wise to collect taxes merely because the government needs revenues. The government has various ways of financing its expenditures, some good

[3] This assumes that public outlays are as high as social priorities require.

and some bad. Taxation is in most circumstances a good method, but it needs nevertheless to be used when, and only when, it is the *best* method. A moderate degree of borrowing—a method that, instead of taking money away from the public, increases their holdings of liquid savings—is frequently to be preferred to one hundred per cent tax financing. Especially is it true that the sale of Series E savings bonds to the mass of the population can typically be recommended as preferable to unduly heavy taxation. Such a policy long pursued, in lieu of excessive mass taxation, would provide increasing security for the population as a whole and thereby strengthen the propensity to consume out of current income.

Compensatory Tax Policy.

Let us return to the problem of compensatory fiscal policy. With a federal budget of 25 to 30 billion dollars, a flexible tax program could have an enormous effect in checking the onset of a depression. In the prewar depression period this was not the case—the budget was too small. In 1929, for example, with annual tax revenues of only 4 billion dollars, even a reduction to zero of all federal taxes could have had relatively little effect on the total income flow. With a budget of 25 to 30 billion dollars, covered largely by taxes, it is evident that tax reduction can become a powerful antidepression device. This is of enormous importance, since admittedly it may be difficult to step up expenditures rapidly enough. Now that we have achieved the notable reform of current collection of all personal income taxes, with the major fraction collected at the source, tax reduction could be put into effect almost instantly on a scale that would have a potent effect in stopping a threatened slump. It is a device that we may well need to cope effectively with a rapidly cumulative recession. We saw in 1937-1938 that a depression can develop with amazing speed. Reliance could certainly not be placed exclusively on a compensatory tax program, but if we make no use of it whatever, we are not likely to find it possible to offset effectively fast-moving fluctuations. This it is of the utmost importance to do, because once started, they tend to gather strength in a cumulative process. We have reached by now a point in economic development at

which variation in tax rates is a very effective weapon so far as short-run adjustments are concerned. In the future the adjustment of tax rates may, as a countercyclical device, take the place formerly occupied by variation in the rate of interest.

As a means of quick adjustment, variation in tax rates is equally as important for the checking of inflationary developments as for checking a cumulative downward spiral. It is therefore an instrument of first-rate importance for achieving *sustained* full employment. A major difficulty confronting a full-employment program is the danger of a rapid cumulation of inflation. Unless there is at hand the means to stop quickly such a development, we shall always be fearful of "getting too close" to full employment.

The tax rate most suitable for adjustment is the basic or standard personal income-tax rate. In any probable postwar tax structure, around 50 to 60 per cent of the total receipts from personal income taxes would come from the standard rate, namely, the rate applied to the first bracket of taxable income. This rate affects *all* income taxpayers; it has the widest application and most affects mass purchasing power. When cut, take-home pay is at once affected and so consumption expenditures are stimulated. When raised, an immediate check is imposed on inflationary developments.

To make this machinery effective, it is evident that the standard or basic income-tax rate would have to be subject to administrative control. Within limits established by Congress, the President should be empowered to raise and lower the standard income-tax rate.

A responsibility so great should not be placed upon anyone except the President himself. If a board, for example, were designated to perform this function, it would become, on the one side, a football for political pressures, and on the other a convenient alibi for the Administration. Only the President, as the leader of the Administration in power and as the elected head of the entire nation, should be loaded with so grave a responsibility. But it is a responsibility that under modern conditions no government can or should attempt to escape. The President should, as a part of his Budget Message, make an annual report to Congress, supplemented by quarterly reports, covering an analysis of conditions

and stating reasons why changes in the rate were or were not made.

The proposal, then, is that the President should be required to review quarterly the revenue receipts from the income tax applicable to individuals for the purpose of ascertaining the extent to which the current and anticipated revenues from this source contribute to stability and full employment. Subject to such principles and standards as the Congress may set forth in applicable revenue acts and other statutes, the basic income-tax rates levied on individuals and the relevant withholding schedules should be varied within limits imposed by legislative enactment to such extent as the President may determine to be necessary or desirable for the purpose of maintaining full employment and economic stability, due consideration being given to the combined effect of this action and other measures taken.

Equally, the President should review all federal outlays with a view to varying the rate of expenditures in such manner as is deemed necessary. This aspect of the matter is considered in some detail in Chap. XVI.

Critics of the proposal to vary the basic income-tax rate will no doubt allege that stability of tax rates is necessary for business confidence. In reply it should be emphasized that it is not proposed to vary corporate income taxes. With respect to proprietors' income derived from unincorporated business, it could be provided that such income is not subject to administrative tax variations from the standard rate. Business policies and decisions involving adjustments to changes in taxes imposed upon business itself would thus not be involved. This proposal, then, does not confront business with uncertainties growing out of changing tax policies. Stability with respect to business taxes is important. The proposal in question affects business only through its influence on sales. The proposal, successfully carried into effect, would promote stable and high sales volume. Far from creating business uncertainties, the effect would be to promote business confidence and business stability.

A Modified Income Tax.

Finally, it is possible to implement the income tax so as to stimulate private investment. A "modified income tax," of the

type suggested by Mr. Kalecki,[4] provides for an abatement of income tax, either in whole or in part, for that part of income that is invested in fixed capital. In other words, deductions would be made from taxable income either of the full amount of new investment or a percentage, say 50 per cent, of new investment. A differential rate would thus apply to income invested in fixed capital. The retained earnings of corporations, for example, which are invested in fixed plant or equipment would either pay no tax or a lower rate of tax, while retained earnings not so invested would pay the full rate. Another variant would apply the tax to gross income prior to the deduction for depreciation and obsolescence but would deduct from taxable income any part invested in fixed capital whether net or for replacement. Still another variant would permit the deduction from taxable income *up to a certain percentage limit,* say 25 or 50 per cent, of the income invested in new fixed capital.[5]

Other Tax Incentives.

In addition, there are other means to adapt taxation so as to promote investment. A 5-year loss carry-forward would encourage risky ventures.[6] The current taxation of long-term capital gains at a maximum rate of 25 per cent operates in the same direction. Accelerated depreciation would permit a firm to pay lower taxes in the first years after an expensive and venturesome new investment had been made. All these devices favor new investment.

Double taxation of dividends, while less serious, I believe, than usually thought to be, nevertheless ought probably to be removed or mitigated. For example, the corporate tax on distributed profits might be reduced to one-half of the rate on the retained part. Complete removal of the tax on the distributed part would in effect be similar to the British system.[7] Suppose a straight rate of 40 or 50 per cent is applied to that part of the net profits of corporations that it is decided not to distribute. No corporate tax would

[4] M. Kalecki, *Economics of Full Employment,* Oxford Institute of Statistics, pp. 45-46.

[5] Alvin H. Hansen and Harvey Perloff, *State and Local Finance in the National Economy,* W. W. Norton & Company, Inc., New York, 1944, p. 248.

[6] For further discussion see Chap. XV.

[7] This method was proposed in Hansen and Perloff, *State and Local Finance in the National Economy,* pp. 257-259.

then be levied on the profits that are distributed to stockholders. The corporate taxes would apply to net profits *after* dividends. Stockholders would be taxed on dividends received, at the individual income-tax rates. As recently stated in the London *Economist,* the so-called "standard" rate in the British individual income tax is really nothing more nor less than the rate paid on retained corporate profits.

This system would not preclude a differential low rate on that part of corporate retained earnings that was invested in fixed capital.

In view of the difficulty with which small corporations are confronted in obtaining funds from the capital market and in view of their greater reliance upon retained earnings for expansion and growth, it might be reasonable to cut the corporate tax rate on incomes of less than $100,000 to, say, one-half of the regular rate.[8] This, and other measures including a technical service supplied by the government, would help to encourage the formation and growth of new small businesses. The benefits in terms of a dynamic society and of opportunity for each oncoming generation could be highly significant.

Kalecki [9] calls attention to the fact that tax incentives designed to stimulate private investment are no solution for the continuous maintenance of full employment. If these devices are to have a continuing effect on employment, they must be applied not once only but cumulatively—the income tax must be *continuously* reduced. This, however, constitutes no good argument against these measures. Indeed, the same argument applies to advances in technique that open up investment outlets. In the interval while the additional investment is being made, employment *is* increased. And thereafter productivity and real income will be higher than would otherwise have been the case by reason of the greater degree of capital intensity.

[8] See Butters and Lintner, *Effect of Federal Taxes on Growing Enterprises,* Boston, 1945.

[9] M. Kalecki, *Full Employment by Stimulating Private Investment?,* Oxford Institute of Statistics.

Chapter XII

Interest-rate Policy

IN THE previous chapter it was suggested that variation of the basic or standard income-tax rate, under modern conditions, is one of the most effective devices to counteract cyclical fluctuations. Formerly, variation in the rate of interest was regarded as the main anticyclical weapon. While occasionally (as in the rather vague reference to interest-rate policy in the British White Paper) the interest rate is still regarded as suitable for this purpose, modern monetary theory has increasingly veered away from this position.

Variation of the Interest Rate Not Feasible.

On grounds of both experience and monetary analysis it is now widely accepted that variation of the rate of interest is not a useful method of control. In a pronounced boom it is the speculative activities that ought to be clubbed down, not the ordinary run of stable industries. An increase in the rate of interest affects hardly at all the high-profit speculative ventures. It is not denied that credit restriction and the increasing pressure of rising interest rate can check a boom, and indeed, if severely applied, turn the economy into a tailspin. But the effect is to undermine sound investment in the economy as a whole, while affecting but little if at all the speculative extravagances of the boom. The sounder parts of the economy, which might contribute substantially to a continuing prosperity, are the very ones hardest hit by a variable interest-rate policy. A serious defect of this device is that it strikes with most force at just the wrong places.

Accordingly, it is increasingly recognized that selective controls are likely to be more effective. For example, one important element in every cycle is the fluctuation in inventory accumulations. But variation in the rate of interest has never been effective as a control mechanism, and in the nature of the case could not be.

If conditions favor an inventory boom, a rise in the rate of interest has virtually no effect. The prospective gains from a rise in inventory prices enormously overshadow any deterrent effect from an increase in the rate of interest. Other more direct means must be found to regularize, more than we have been able to in the past, violent fluctuations in inventory accumulations. It may be that adequate information about inventory stocks have a restraining effect. It may be that some tax incentive can be found to meet this problem. Control of credit cannot do the job. It never has in the past.

The experience of the twenties similarly indicates that variation in the rate of interest is not effective as a means of curbing excessive stock-market speculation. With respect to loans on the stock market, fairly effective direct controls are now available in the margin requirements and in the powers of the Federal Reserve Board to alter these requirements.

With respect to consumer loans, again variation in the rate of interest is no serious deterrent to undue expansion. Direct controls over consumer credit were exercised during the war in the form of credit regulations imposed by the Federal Reserve Board. The power to institute such controls, whenever necessary, ought to be continued into peacetime. Normally the powers would not be used, but they could and should be exercised if consumer credit began to reveal inflationary potentialities.

With respect to real-estate speculation, past experience indicates that a mere rise in the rate of interest is a wholly ineffective device. It is believed, however, that the Federal Housing Administration can in various ways exercise a restraining influence in the case of urban real estate. It may be that the FHA should be given additional powers in this direction. With respect to rural real estate, we are in need of some means to control speculation in farm land. It may be that a special kind of capital-gains tax might serve. At all events, experience following the last war indicates very clearly that a mere increase in the rate of interest is quite ineffective as a means of controlling inflationary and highly speculative developments in farm-land values.

A further argument against cyclical variation in the interest rate is the difficulty of getting the rate down again once it has been raised sufficiently to check an inflationary boom. It is no

easy matter to reduce the rate in the ensuing depression, and thereby promote recovery. Especially is this true for precisely these areas in which the interest rate is important. During the depression of the thirties we have seen (despite the extraordinary degree of liquidity registering itself in low yields in the gilt-edge bond market) how difficult it was to reduce the rate adequately on urban mortgages and on loans in rural communities and for small business. The difficulty of getting the rate down, once it has been raised in the boom period, and the deterrent effect that a high rate has on recovery, present a strong argument against the use of this device as a regulatory mechanism.

Variation in the interest rate was more or less suitable to the period in which commercial loans ruled the money market. This is no longer the case. From 1920 on throughout the boom of the twenties, genuine commercial loans did not rise, and as a proportion of total bank assets they continuously declined. This tendency was accelerated through the thirties. That it will be even more pronounced in the postwar years is indicated by the large volume of cash and securities held by business concerns. There is no probability that there will be any large resort to commercial loans in the postwar period. Accordingly, the money supply (demand deposits and currency) is no longer a function, as formerly, of the volume of commercial loans. In the future we cannot expect demand deposits to grow appreciably[1] except on the basis of (1) bank investments in securities, public and private, and (2) loans on real estate.

Under conditions now prevailing in all advanced industrial countries, the total volume of private property claims held in the form of long-term securities, public and private, represents a high proportion of the aggregate money value of all property claims, including equities of all kinds. Under these circumstances, substantial variations in the rate of interest would have serious consequences upon property values. Such fluctuations in the value of a major portion of outstanding property claims could not fail to have a seriously disturbing effect upon the business community and would unfavorably affect the volume of outlays for both new investment and consumption. The vast holdings of securities by the public generally, by business concerns, and by financial institu-

[1] To a limited extent consumer loans may be expected to increase.

tions, preclude the use of a variable interest rate as an instrument of monetary policy.

The rate of interest, under present conditions, is not a feasible instrument of cycle policy. Adjusted cyclically up and down, it would carry with it gigantic fluctuations in the value of all outstanding securities. Such fluctuations are not tolerable.

As a long-run policy a high rate of interest is equally impractical. It would nullify present plans to extend the area of new private housing down to relatively low-income groups. It would raise the burden of debt on farm mortgages (now only half as great as a decade ago). It would raise the burden of debt for public utilities and railroads and so tend to raise rates and costs to all lines of business. It would restrict here and there throughout the economy the volume of investment in fixed capital.

Advantages of Low Interest Rate.

Modern economic analysis favors the maintenance of a low rate of interest. This also is the announced policy of all modern democracies. Sir John Anderson, Chancellor of the Exchequer in Great Britain under the Churchill government, made the following statement in the House of Commons on Apr. 24, 1945:

"The average rate of interest on the national debt in 1938 was 3.1%. It is now 2.3%. Few people before the war would have believed the possibility of what has been actually achieved. With this experience behind us I reiterate the practical possibility as well as the advisability of low interest rates after the war, although I believe it is wise to move gradually and to avoid sensational changes in a factor so interwoven as is the rate of interest with our social as well as our economic fabric. The favorable effect on the finance, for example, of the housing programme is obvious. But that is no more than one impressive example of the beneficent effects which will be felt in many directions. . . . We shall aim, I hope, at low rates of interest and stability of prices without deflation."

In the annual report of the Bank of Canada, Feb. 10, 1944, Governor Towers effectively stated the case for a low rate of interest, as follows:

"A policy aimed at higher interest rates would only become intelligible if, after the war shortages are over, consumers' expendi-

ture and capital development were to proceed at a rate which would overstrain our productive capacity. I see no prospect of such a situation arising in a form which would call for a policy of raising interest rates. Admittedly, the rate of interest is only one of many factors influencing Canada's economic position, and it is probably not as important an instrument of control as was once supposed. It remains true, however, that the prospect of unstable interest rates could make it exceedingly difficult for business to formulate long-term plans. Moreover, high borrowing costs would hamper new investment in plant, equipment, and housing, would restrict the expansion of employment, and would seriously complicate the task of government financing. There can be little doubt that the easy money policy which has been pursued since 1935 assisted in promoting recovery from the depression and facilitated the adjustments which have been required during the war period. Indications that the Bank intends to continue this easy money policy should be helpful in making plans for the future."

In the United States also, responsible public officials have supported the policy of a continued low rate of interest. Thus in the *Annual Report of the Secretary of the Treasury to Congress* for the fiscal year ended June 30, 1944, we find:

"The low level of interest rates on the public debt (the computed interest rate on June 30, 1944, was 1.93 per cent) lightens the burden of the debt and will tend to simplify debt management in the post-war period. Moreover, the fundamental factors underlying interest rates on government securities, which apply also to interest rates in other fields, give no indication of a change in the direction of a higher level of rates in the foreseeable future. Continued low interest rates will be a major contribution to economic stability and the maintenance of full employment after the war, for low interest rates stimulate business and encourage new enterprise."

The value of long-term government bonds should be stabilized with a minimum of fluctuation. It may possibly be sound policy to prevent the long-term bond market from rising progressively above the current high figure. This, indeed, may involve a control of the volume of excess bank reserves and especially of the short-term rate. In order to maintain the value of government bonds and prevent them from falling, a high degree of liquidity

in the banking system will indeed be needed. But excess reserves should not be permitted to rise[2] to a point that would tempt banks out too far into long-terms, resulting in an excessive rise in the value of governments and high-grade private bonds. What the desirable level of interest rates may be a decade or so hence I do not pretend to know, but for the immediate years ahead I think we should do well to stabilize around present levels. If over the long run it proves desirable to lower still further the interest rate, the process should be a slow and gradual one. As Sir John Anderson said, sharp changes should be avoided in a factor so interwoven with the economic fabric.

If the interest rate on government bonds is maintained at approximately its present level, it follows that the interest rate on high-grade corporate bonds will also continue low in line with the government interest rate. This, to be sure, means that corporations can secure funds in the capital market on very favorable terms. Are there inflationary dangers in this situation? I think not. In the first place, internal sources of financing are increasingly important and the volume of new financing in the market is relatively small. It was even extraordinarily small in the good years of the twenties, amounting in the best years to less than 2 billion dollars a year. It is true that the gross volume of new issues floated was many times this amount, but this was due to the speculative orgy in which layer upon layer of speculative issues of holding companies and investment trusts was formed. The danger that there will be excessive flotation of securities of a genuine character in the capital markets is negligible, I think, in view of the development of internal financing.[3]

We are thus driven back fundamentally to selective control measures in various directions as indicated above, and finally to fiscal policy, taxation, and expenditures, as the over-all mechan-

[2] Under the existing practice, commercial banks can add to their reserves by selling short-term obligations to the Federal Reserve Banks. This follows from wartime established policy to maintain the wide spread between short-term and long-term rates. Under this pattern of maintained rates, it is profitable for the banks to sell short-term obligations to the Federal Reserve Banks, thereby acquiring additional reserves; and on the basis of these expanded reserves a multiple purchase of medium-term bonds can be made.

[3] *Cf. Financing American Prosperity,* Twentieth Century Fund, 1945, Chap. 5.

ism of control. This is a powerful weapon, particularly in view of the large postwar federal budget. We must not only balance the budget, but produce a budgetary surplus, if need be, to hold inflationary tendencies in check. It is within the framework of selective controls in various areas, and over-all fiscal control, that we must operate if we mean to achieve economic stability, avoiding both inflation and deflation.

Chapter XIII

Wage Policy

IN AN article in the August, 1944, issue of *Agenda,* Professor Pigou presents the following equation as an aid to the analysis of wage policy.[1]

$$E = p\,\frac{O}{w}$$

In this equation E represents the number employed, O is relevant outlay or total money income (wage and nonwage), p is the proportion of total money income going to wages, and w is the average *rate* of wages. Obviously $Ew = pO$. The equation is an arithmetical truism.

Elements Omitted.

In the equation as given by Pigou the suggestion is that E is determined in some way by the other three items. This is rather dangerous, especially since many other relevant items are not included in the equation. Especially unfortunate is the fact that such important factors as unit costs, unit prices, and aggregate output are not considered.

An Interdependent Complex.

Pigou at once warns that we cannot assume that the three items (p, O, and w) are independent of one another. Rather, they are a complex which must be regarded as a whole. Total money income is not independent of the wage rate. The "new economics," he says, maintains the view that attempts to improve employ-

[1] A similar analysis is given in his *Lapses from Full Employment,* The Macmillan Company, New York, 1945. In the preface to this volume Professor Pigou says: "Professor Dennis Robertson, who has very kindly read my proofs, has warned me that the form of the book may suggest that I am in favor of attacking the problem of unemployment by manipulating wages rather than by manipulating demand. I wish, therefore, to say clearly that this is not so."

ment by cutting down the mean rate of wages are foredoomed to failure, because any reduction in the wage rate would carry with it an equiproportionate reduction in relevant outlay or money income. Pigou accepts this view only in the special case in which the money rate of interest is prevented from falling whenever downward pressure is exerted on it through lower wage rates. At all events, whether or not wage reductions would in fact promote employment, he admits that in the modern world it has no chance of being tried. There remain, therefore, he argues, the powerful remedies for unemployment, (1) changing the proportion of total income going to the wage bill,[2] and (2) expanding the total income or relevant outlay. And if both full employment and stability are to be achieved, it is necessary to impose a check on increases in wage rates.

Disequilibrium in Wage-profit Ratio.

Consider an economy running along on a fairly stabilized level with a large amount of unemployment, as was roughly the situation in the United States in 1937-1940. Let us assume, for the sake of the argument, that in this circumstance wage rates were too high. This might be taken to mean that unit labor costs were under the prevailing conditions too high to permit a normal rate of profit per unit of output. This would mean that the distribution of income was distorted away from equilibrium, the ratio of wages to profits being high[3] This is typically the situation in every period of depression. On the other side, in boom periods the ratio of profits to wages is disproportionately large.

Wage Reduction Tends to Lower Aggregate Demand.

Not only is it politically difficult in periods of unemployment to cure the distortion, as Pigou points out, by the method of wage

[2] This Pigou would achieve by improving labor mobility. This would ensure that whatever jobs are available, under any given aggregate outlay, would tend to be filled speedily, thus raising the proportion of wages to income. More important, I think, is the possibility of raising the proportion going to wages under full-employment conditions, under which high sales volume would continuously be maintained.

[3] It is often said that the share of total income going to wages is highly constant. This is largely true, but profits are low in depression while fixed overhead remains unchanged. Thus the ratio of wages to profits is likely to be high in periods of depression and unemployment.

reduction; it is also highly questionable that wage reduction will accomplish the purpose. Wage reduction not only decreases unit costs; it will also reduce the wage income of all employed workers. Therefore, unless monetary and fiscal action is taken to prevent liquid assets from falling along with the decline in income, no increase in employment will occur. Moreover, from the short-run standpoint, unless the cut in wages could be achieved once and for all on a controlled nation-wide basis, a general crumbling of wage rates, with successive cuts in one industry after another, is likely to arouse unfavorable expectations with deflationary consequences.

Two Ways to Improve Profits-wage Ratio.

If wage reduction is ruled out, there are two ways, as I see it, starting from a condition of underemployment, by which the ratio of profits to wages can be improved if this ratio is too low. One is the continuous process of cost-reducing improvements in methods of production; the other is to raise aggregate demand. The latter may be accomplished either by an increase in private investment or through public outlays.

The increase in aggregate demand (overhead costs remaining constant) may lower total unit costs as output rises. Total profits would continue to rise up to the point at which marginal cost equals marginal revenue. A wage rate that was too high on the basis of restricted output may prove quite all right as soon as sales volume goes up substantially. Thus if the wage rate was too high in 1939, when Gross National Product was only 88.5 billion dollars, it was none too high (even after some considerable increase) in 1941, when Gross National Product had risen to 120.5 billion dollars. Cyclically, some increase in real wages is therefore possible in view of the decline in unit cost at fuller utilization of capacity; secularly, an increase in real wages depends upon the improvement of production techniques.

Wage Increases in Periods of Expansion.

It is sometimes said that an expansion in aggregate demand will not increase employment unless real wage rates are kept stable. But this is a matter of degree and in particular must be related to changes in sales volume and in technique. If wage rates were

raised more than the increase in productivity, the increase in labor cost would impose limits on the expansion of employment. For in this case the increase in labor cost might raise prices so high that the enlarged aggregate outlay could buy no more goods than before. That being the case, expansion would only produce inflation, with no improvement in employment.

This is quite possible. But it does not follow that *no* increases in real wage rates are possible. If higher money wages are balanced by increases in productivity,[4] real wage rates may rise (the price level remaining constant) without raising labor costs. Alternatively, the gains in productivity, springing from fuller utilization of existing capacity and from changes in techniques, may be taken partly in higher real wages and partly in an increase in employment. Aggregate demand is raised and marginal revenue curves are pushed to the right. Under this process, employment can profitably be increased until marginal cost equals marginal revenue. Thus it is not true that any increase in real wage rates would necessarily prevent all expansion. The increase in aggregate real demand would be reflected partly in increased employment and partly in rising per capita real income.

[4] It is sometimes assumed that increases in man-hour productivity occur mainly in depression periods This is not in accord with American experience, as the following table will show:

INCREASES IN MAN-HOUR PRODUCTIVITY
(1939 = 100)

Year	Manufacturing	Railroad transportation	Mining
1922	57.9	60.9	57.5
1929	75.5	75 1	69 9
1933	82 9	83 0	78.8
1941	107.1	115.5	104 2

SOURCE: Bureau of Labor Statistics, *Basic Facts on Employment and Production*, Senate Committee Print No. 4, Committee on Banking and Currency, 79th Congress, 1st session.

Man-hour productivity in manufacturing remained about constant from 1914 to 1919, but rose sharply from 1919 to 1922 at approximately the same rate in the prosperity period 1919-1920 as in the depression period 1921-1922 inclusive.

Aggregate demand, output, and employment could, it is true, as a matter of pure logic, equally well be promoted by taking out the gains of increased productivity in price reduction instead of in wage increases. But in terms of frictions and social adjustments, the advantage lies with wage increases.

Experience in the cycle indicates that in modern large-scale industry, in contrast with agriculture, the unit variable cost curve tends to decrease over a wide range of output.[5] Thus as aggregate demand is increased, expansion of output and employment is not likely to be checked from the cost side until substantially full utilization of the fixed plant is approached. An expansion of aggregate demand will therefore tend to induce larger output and employment at substantially stable prices for finished industrial products.

The typical recovery process [6] belies the statement so frequently encountered that no expansion can occur in output and employment without a decrease in real wage rates. This statement would be true only if the following conditions are assumed: (1) no change in organization, equipment, or technique, and (2) no increase in aggregate demand. In the dynamic process of expansion it is not true that there is a unique inverse relation between real wage rates and employment.[7]

Static vs. Dynamic Approach.

The analysis given above reveals the difference between the static and the dynamic approach to the problem of an equilibrium wage rate.[8] From the static standpoint, a reduction in the wage rate may restore equilibrium in the profit-wage ratio. If we could hold everything else constant, as is assumed in the static analysis, wage cuts would increase employment. But in the dynamics of

[5] R. A. Lester finds that unit variable costs decrease all along the scale between 70 and 100 per cent of plant capacity. See *American Economic Review,* March, 1946.

[6] See in this connection the excellent discussion by J. M. Clark in *Financing American Prosperity,* Twentieth Century Fund, p. 114.

[7] The rigorous assumptions laid down by Keynes in the *General Theory* (p. 17) are too often forgotten. Moreover, Keynes reformulated his own views on a more realistic basis in his article on "Relative Movements of Real Wages and Output," *Economic Journal,* March, 1939.

[8] See also Alvin H. Hansen, *Fiscal Policy and Business Cycles,* pp. 246-247; 332-326.

the problem, the other elements will not stay put. It is thus not possible to arrive at any such simplified conclusion. Accordingly, practical policy points to (1) cost-reducing improvements and (2) enlargement of aggregate outlay as means to restore an equilibrium profit rate. But this requires that wage rates shall not be increased beyond the equilibrium rate.[9] Normally the process of expansion of output and employment is promoted, for the reasons stated above, by such increases in money wage rates as are justified by increases in productivity. Thus the dynamic analysis reveals that the problem is far more complex than is indicated by the overly simplified and unrealistic static analysis.[10]

Responsible Wage Policy.

The general conclusion is that wage policy, as a means to promote full employment, cannot follow any simple rule of thumb. It is not true, as the older analysis had it, that wage reduction (if it were politically possible) would under all circumstances increase employment. Expansion of total outlay is basic and fundamental as a means to cure unemployment and restore profit margins. But *cost* reduction is also important. And in the process the wage rate must not be permitted to rise above the full-employment equilibrium rate. If it goes beyond this, we should sacrifice either full employment or stability in the value of money. Accordingly, limits must be imposed on wage-rate increases if these twin goals are to be achieved. "So long as freedom of collective bargaining is maintained, the primary responsibility for preventing a full employment policy from coming to grief in a vicious spiral of wages and prices will rest on those who control the bargaining on behalf of labor." [11]

This responsibility involves not only the *level* of wage rates but also the *structure* of wage rates. We cannot achieve full em-

[9] The equilibrium wage rate can have no real meaning except in terms of a given volume of output. From the long-run standpoint it means the rate appropriate to the condition of reasonably full utilization of fixed plant. Under normal capacity output, the long-run equilibrium wage rate will ensure a normal rate of profit.

[10] While Pigou sought (by viewing the three items in his equation as an interdependent complex) to free his equation from the limitations of the static analysis, the discussion reveals that he does not altogether succeed.

[11] Sir William Beveridge, *Full Employment in a Free Society*, p. 200.

ployment and a balanced development if we allow building trades wage rates, for example, to rise far out of line with the general wage structure. If this should happen, wage earners could not afford with their relatively low incomes (low in comparison with the building trades) to buy houses that are priced out of the market by reason of high labor cost.[12]

A full-employment wage policy thus involves (1) control of the level of wage rates, as aggregate demand is expanded, so as to promote an equilibrium ratio of wages to profits, on the one side, and prevent increases in unit costs and prices on the other; (2) a balanced wage structure so as to prevent important products (construction, for example) from being priced out of the market; (3) cost reductions, involving both advances in techniques and removal of monopolistic and restrictive practices.

The Annual Wage.

To a degree the guaranteed annual wage is already an achieved fact.[13] And it is expanding. Could it be made universal, and if so at what per cent of full-time annual earnings?

Guaranteed wages are already in effect in some parts of our society.

[12] The illustration used above is not intended to suggest that the annual wages of construction workers are in fact too high in the United States. Annual earnings are in fact low by reason of the high instability, seasonal and cyclical, of the industry. But construction costs *are* too high. They can and should be reduced partly by a program to stabilize the industry and thereby achieve a more effective utilization of labor, partly by a removal of restrictive practices both by labor unions and industry combinations that affect prices and by the use of materials and equipment. Obsolete building codes often prevent full use of technological advances and raise costs. Modernized procedures together with a vigorous antimonopoly program are urgently needed.

"Up to the present time no effort to break up the traditional restraints has had more than a short success. A few states have made sporadic forays, and both the Federal Trade Commission and the Department of Justice have attempted to use the authority of federal legislation against such restraints. Due, however, to the extreme localism of most construction activities, the federal government has never been able to obtain more than a partial jurisdiction. The result is that there has been no complete and consistent authority to prevent local monopolies in the construction field." See Miles L. Colean, *Stabilizing the Construction Industry,* National Planning Association, p. 20.

[13] See Jack E. Chernick and J. C. Hellickson, *Guaranteed Annual Wages,* University of Minnesota Press, Minneapolis, 1945; also "Symposium on Guaranteed Wage," *Commercial and Financial Chronicle,* Sept. 13, 1945.

Among those who enjoy more or less, through security of tenure or otherwise, the equivalent of an annual wage are: civil servants, federal, state, and local; teachers; some sections of the office staffs of corporations; and many professional workers. But with respect to wage earners in general, there is typically no such protection. The incidence of fluctuations in national income has historically as a matter of course fallen upon the general mass of wage earners.

Nevertheless, experimentation with the annual wage is going on. There are at least 650 firms in the United States that have some form of annual wage plan. Such a plan may involve the guarantee to pay a minimum annual wage regardless of the time actually worked, or it may involve a guarantee of employment for a minimum period, say 30, 40, or 50 weeks, in the year. The plans actually in operation often do not extend to all employees. One illustration, for example, is a plan which gives employees with 5 years of service 30 weeks' employment in the year. State unemployment insurance would give partial protection for the remainder of the year. The Hormel Plant in Austin, Minnesota, guarantees an employee who is taken on the pay roll up to 52 weeks of pay in the next 12-month period.

Analysis of the past employment experience will reveal an array ranging from industries where employment is highly fluctuating to those with highly stabilized employment. The guaranteed wage can be adjusted in a flexible manner to the requirements of different industries. All industries, within limits imposed by the nature of the industry, could probably do *something* toward establishing a limited annual wage. It is no good answer to say that the annual wage can be most perfectly applied where it is least needed. If all industries, wherever they fall in the range of employment experience, assumed *some* part of the risk of unemployment, there would be a general gain in security of income throughout the entire economy. If past experience in an establishment indicated that a firm could guarantee full-year employment to 60 per cent of its employees, it might risk guaranteeing steady employment to 65 per cent. If experience indicated 30 weeks' steady employment, the management might be able to plan a program that would guarantee 35 weeks' income per year.

The progressive setting of higher and higher goals would probably fail unless an over-all full-employment program were under-

taken by the nation as a whole. The programs of the different individual firms and the general national full-employment program would each reenforce the other.

In connection with the annual wage, it is important to recognize that not all individuals who enter the labor market during any year are full-time workers. Thus for the year 1950, it is estimated that there would be 11 million seasonal and intermittent workers, 1.7 million new entrants to the labor market during the year, 1.3 million old people retiring from the labor market during the year, 52 million full-time members of the labor force, and 66 million individuals in the labor market sometime during the year.[14] A distinction must thus be made between (1) the total number of individuals seeking work sometime during the year, (2) the average labor force, (3) the full-time members of the labor force. The annual wage could cover only a part of the latter category. Even though a guaranteed annual wage were applied throughout industry, there would still be fluctuations in income springing from seasonal, part-time, and overtime employment.

Guaranteed minimum annual wages are no panacea. If relied upon alone, they would entirely fail. They can, however, in combination with social-security measures, and within the general framework of an over-all full-employment program, play a useful and significant role.[15]

[14] National Planning Association, *National Budgets for Full Employment*, pp. 60-61.

[15] For discussion and further consideration I should like to throw out the following suggestion. While a full-employment Gross National Product must be the *goal* of national policy, in practice it can be achieved only within limits which one may hope can progressively be narrowed. It may however be feasible for the federal government to underwrite, with the cooperation of business, labor, and agriculture, a *minimum* Gross National Product at substantially stable prices. This would not appear to be a utopian proposal. If this were undertaken, it could then be estimated with a fair degree of accuracy what the demand would be for steel, textiles, food, etc., at this *minimum* Gross National Product (say 80 per cent of a full employment G N.P.). On this basis a corporation or firm might then enter into a collective agreement to guarantee an annual wage for a specified minimum number of weeks. A central insurance pool to which all industries would contribute (as in the case of the FDIC with respect to banks) might be set up to ensure, within limits, the ability of the corporation or firm to make good on this commitment. Unemployment insurance would carry the workers, in the event that alternative employment were not available, during the weeks not covered by the guaranteed annual wage.

Chapter XIV

Consumption

A SCHEDULE showing the volume of consumption outlays at various income levels sets forth in tabular form the relationship between two variables (consumption and income) This relationship in technical economic terminology is referred to as "the propensity to consume" or as "the consumption function."

Two Consumption Functions.

Such a schedule can be constructed, among others, in at least two different ways: (1) a table showing a range of family incomes, say from $500 to $1,000,000 or more, together with the amounts that families on the average spend on consumers' goods and services at each income level; (2) a table showing the figures (stated in absolute numbers) of the national income in the various years of an entire cycle, ranging from the bottom of a depression to the peak of a boom, together with the total amount of private consumption expenditures made in the nation as a whole at each national-income level.

These two quite different kinds of schedules [1] are often confused, and sometimes in the course of a discussion a jump is made from one to the other with the result that wholly erroneous conclusions are often drawn.

National Consumption Function.

The latter schedule, showing the ranges of consumption and total income over an entire business cycle, may be generalized by combining the data for different cycles. This could be done, for example, by throwing all the figures for each cycle into index numbers. The peak income for each cycle is then taken to equal

[1] The former might well be called the "family consumption function" and the latter the "national consumption function." See Chap. IV.

100, and all the figures of consumption and income for that cycle are cast into relatives of this base. In this manner the data for different cycles, widely separated in time, and with consumption and income figures of widely different absolute magnitudes, can be made fairly comparable. The method suggested is, however, rather crude, for one thing, because the common base (index = 100) relates for each cycle to the peak income. But the peak income for one cycle may have fallen far short of full recovery, or, in other words, far short of a full-employment income; for another cycle, however, the peak income may have been reached at full employment. Thus the two bases (both 100) are not really comparable. Obviously it would be a considerable improvement if the index number 100 for each cycle referred to a "full-employment" income. On this basis the index numbers for consumption and for income would always relate the actual data for any given year to a full-employment income for that given cycle.

Long-run Considerations.

Let us suppose that such a set of index numbers for consumption and income could be constructed for the cycle culminating in the boom of 1873 and also for the cycle culminating in 1929. If, now, it were found that the consumption relatives corresponding to each income relative were approximately the same with respect to both cycles, we could then conclude that, secularly, the consumption function had not changed. At *any given income level* (100 being "full employment" in each period) the same percentage of the total income was consumed in both cycles. Accordingly, if this were the case, the "consumption function" *over the long run* would be found to be stable.

This proposition was fully discussed, though in more general terms, in Chap. XI of my *Fiscal Policy and Business Cycles,* especially on pages 231-234. It was elaborated upon by Professor Paul Samuelson in Chap. II, *Post-war Economic Problems,* edited by Seymour Harris. Briefly the proposition is that the consumption function (stated in terms of *absolute* magnitudes) has shifted upward from cycle to cycle, as a result of the secular rise in productivity and in living standards, so as to yield a "stable relation be-

tween percentage consumed out of national incomes corresponding to a given fraction of *full-employment* income." [2]

To the extent that each cycle shows the same general consumption-income pattern ("full-employment" income = 100) the consumption function may be regarded as stable.

In each cycle, as income rose from the bottom of the depression, the schedule reveals that consumption also rose but at a less than proportional rate. From cycle to cycle, however, consumption rose proportionally with income.[3] In fact the consumption function in recent decades (the war years omitted) appears to be approximately similar to that of former decades. Over the long run the standard of consumption has risen roughly in proportion to increases in productivity and income.

Some have inferred that long-run stability in the consumption function, as stated above, leads to the conclusion that there can be no savings-investment problem But this is not the case. It is true, however, if the consumption function is stable secularly, that the savings-investment problem will not grow *worse* over the long run. It means that the savings-investment problem is always present from cycle to cycle, or from decade to decade, in the *same degree*. In each period, the consumption function being given, the level of income will depend upon the volume of investment.[4]

[2] *Post-war Economic Problems*, p. 33. Statistical support for this thesis is found, roughly, in S Kuznets, "Capital Formation, 1879-1938," *Studies in Economics and Industrial Relations*, Philadelphia, 1941, pp. 53-78.

[3] Thus, for example, if the following schedule applied to two cycles separated by, say, 50 years, we should say that the consumption function, secularly, was stable.

(100 = "Full-employment income")

Year	Income	Consumption
1	60	60
2	70	66
3	80	73
4	90	80
5	100	85

[4] "Investment" here means (1) private investment and governmental loan expenditures.

In general such data as we have up to World War II support the hypothesis of a relatively stable function over the long run, or at least a very slowly changing one. How far the terrific impact of the events of World War II, together with the institutional changes it has brought about, will modify the consumption-income pattern it is impossible to say now. No relationship, however stable, is likely to remain unaffected by a shock of this magnitude.

Tax-financed Outlays.

The great expansion that is envisioned in postwar public outlays compared with prewar must be taken account of in our income equation. Thus, we may write $Y = C' + I'$, in which $Y =$ Net National Product; $C' = C + T$ (C being private consumption and T being tax-financed public outlays); $I' = I + L$ (I being private investment while L is loan-financed public outlays). Clearly the magnitude of tax-financed public outlays may profoundly affect the ratio of C to Y at each income level.

A large increase in tax-financed outlays cannot fail to affect the private consumption-income pattern. How the consumption function will be affected will depend in large measure upon the character, no less than the magnitude, of the taxes. If the change in the tax structure is such that the funds are largely abstracted from the general mass of consumers, the induced decline in consumption will be very great. If, however, the change in the tax structure hits mainly the upper income classes, then it is the savings function that is substantially changed while the consumption function (private consumer outlays) will be left relatively undisturbed If it is assumed that the change in the tax structure cuts both ways, both savings and consumption are reduced at various income levels. The more the tax structure restrains consumption at different income levels, the larger the volume of public outlays and private investment needed to produce full employment. The more the tax structure lowers the savings function, the less the volume of public outlays and private investment needed to produce full employment.

Large tax-financed public outlays would do as well as loan-financed expenditures to stimulate employment and enlarge the

flow of income if the taxes did not restrict consumption. But this is scarcely possible. Loan-financed expenditures are therefore more effective since they do not infringe on consumption.

Taxes, Savings, and Consumption.

A change in the tax structure will cause a shift in the consumption and savings functions. But if we assume the tax structure as given, the consumption and savings functions are likely to be fairly stable at least in the short run. Accordingly, we may say that, with a fixed structure of tax *rates,* consumption, taxes, and net savings are all functions of the Net National Product. As the Net National Product rises and falls, each of the dependent variables rises and falls in conformity with a fairly standard pattern. These functional relationships may be illustrated in the following purely hypothetical table:

NET NATIONAL PRODUCT AND DEPENDENT VARIABLES

(In billions of dollars)

Net national product	Consumption	Taxes*	Net savings
100	85	15	0
125	95	20	10
150	105	25	20
175	120	30	25

* Tax *rates* are here assumed to be fixed; the increase in tax revenues shown in the table is due to the increase in income and also to the progressivity of the tax structure, not to changes in tax rates.

A Pleasant Predicament.

Sharp changes in tax rates will likely alter the consumption function very quickly. Other structural changes in institutions and in behavior patterns (customs and habits) are likely to operate more slowly. If a sudden structural shift occurs in the general level of the national product (of which an unprecedented illustration is the experience we have recently passed through), there is likely to occur a lag in the adjustment of the pattern of consumption in relation to the Net National Product. Secretary Vinson made a humorous reference to this difficulty in his last report as Director

of War Mobilization and Reconversion, which he repeated in the hearings on the Full Employment bill. He said: "The American people are in the pleasant predicament of having to learn to live 50 per cent better than they have ever lived before." It is no easy matter in a highly complicated society to make the adjustments necessary all of a sudden "to live 50 per cent better."

As Secretary Vinson so well said, unless we base our economy on the "foundation of mass consumption," the structure will not be stable. In modern communities the consumption function tends to be too low; the savings function too high. This condition is due in part to the distribution of income as conditioned by the manner in which the value of the product is distributed to the factors of production under the operation of the price system. Since the modern economic system fluctuates violently, a disproportionately large volume of current savings tends to be generated at high income and employment levels. Moreover, there is the necessity (without adequate security and protection against unemployment, sickness, accident, and old age) for indiividuals at all income levels to save as much as possible from current income. In consequence a rational and economically balanced disposition of income between consumption and savings is not made in any advanced modern community. At continuously high levels of income and employment, no more savings should be generated than are required to take care of growth and technological change. To achieve this balanced relation is no easy matter. This, indeed, is the essence of the highly complicated and difficult problem of maintaining economic equilibrium and full employment.

It has been suggested, notably by the followers of the Social Credit philosophy and variants thereof, that the simple and obviously direct method of ensuring adequately high levels of consumption is to pay money out to consumers as a supplement to income earned in the productive process. As a general procedure to be applied to everyone without regard to need or social priorities, this proposal is by a good deal not within the range of practical politics in any modern democracy. It violates the fundamental principle upon which these societies are currently organized, namely, that reward be adjusted broadly according to the economic significance of the services rendered.

Minimum Consumption Standards.

But while any proposal simply to underwrite consumption by paying out money to consumers generally is not acceptable, modern democracies have already gone a long way in effecting a secondary redistribution of income so that the end result is considerably different from what might be expected were the price system allowed to be *finally* determining with respect to income distribution. Thus, by means of minimum-wage legislation, social security, public-welfare subsidies of various kinds, family-allowance systems, subsidized public housing for low-income groups, free school lunches, free education, free highways, parks, playgrounds, public libraries, and other free community services, the consumption of goods and services partially publicly financed is undergoing a gradual transformation. These are carefully considered, selective ways of raising the level of consumption. They are not ways of distributing purchasing power to consumers in a wholesale fashion. They do not automatically ensure or underwrite any level of consumption regarded as necessary to maintain full employment. They are intended, however, to establish certain *minimum* consumption standards for all citizens throughout the nation. They are directed specifically at the points where the needs are greatest. Guided by the criteria of social utility and social priorities, they are directed primarily at the goal of *optimum* use of resources and only secondarily at the goal of *full* use of resources. Together with other measures, however, they play an important part in a full-employment program.

The areas in which the United States, the richest country in the world, is incredibly deficient are (1) health, (2) nutrition, (3) education, (4) housing.

The American public is only dimly aware how serious these deficiencies are. For this economists are partly to blame. They have devoted far too little attention to an analysis of social priorities and the optimum allocation of resources. They have not adequately explored how far the needs of a modern country can best be served by public activities of different kinds. The mere functioning of the price system, however perfect, will never rid us of slums, provide satisfactory educational opportunities, or ensure adequate nutritional and health standards. As Sir William

Beveridge has so well said: "We should regard Want, Disease, Ignorance and Squalor as common enemies of all of us, not as enemies with whom each individual may seek a separate peace, escaping himself to personal prosperity while leaving his fellows in their clutches. That is the meaning of social conscience." [5]

Housing Needs.

Nowhere is this principle more applicable than in the case of slums and substandard housing. The 1940 Housing Census disclosed the fact that there were then around 7,000,000 substandard urban houses in the United States. The number is being added to each year through depreciation and obsolescence. In the two decades of the interwar years the rate of demolition of substandard houses was only 40,000 per annum. At that rate it would take 200 years to get rid of the substandard houses in existence in 1940 without taking account of the net annual accretions to obsolete properties.

In the immediate postwar years we encounter a serious housing shortage of some 3,000,000 units or more. It will take some years to supply all urban families with any kind of a house, including the substandard ones. Once this urgent shortage is overcome, we should undertake a systematic program of demolition. The National Housing Agency has suggested a minimum demolition program of 600,000 units per year. Even with a 10-year demolition program of this magnitude (15 times the prewar rate), it is estimated, considering the net accretions during the interval, that there would still remain 3.5 million substandard units to be replaced. Thus the job, after a decade of drastic demolition, would still be only half done.[6]

The National Housing Agency has suggested a 10-year program of new construction of 12,600,000 units for 10 years for replacement and growing population needs.

Senator Wagner, in presenting the General Housing bill, S. 1592 (sponsored by himself and Senators Ellender and Taft) to the Senate, Nov. 14, 1945, said: "It is estimated that, exclusive of farm areas, we ought to build about 1,260,000 units of housing a

[5] *Full Employment in a Free Society,* pp. 254-255.

[6] See National Housing Agency, *National Housing Bulletin 1,* November, 1944.

year for the next 10 years. Of these, about 420,000 units will be required for the upper income groups who can pay more than $40 a month, on the average, for their housing. About 480,000 units will be needed for the middle income groups, who can pay, on the average, between $20 and $40 a month for their housing. And about 360,000 units will be needed for the low income groups, who can pay, on the average, below $20 a month for their housing."

For the upper groups existing legislation, especially the mortgage-lending facilities available under the Federal Housing Administration, is adequate. The needs of the middle-income groups (rentals $20 to $40 per month) are provided for in the bill by new programs of FHA insurance. For the low-income group (rentals under $20) the bill provides for 125,000 units a year for a 4-year period. Should employment or housing conditions so justify, the President may accelerate the program, bunching the total 500,000 units in a shorter period.

In the case of houses for the middle-income group the bill provides that the FHA may insure mortgages up to 95 per cent of the appraised value for houses costing under $5,000, with the amortization period extended to 32 years and an interest rate of 4 per cent. The bill also provides mortgage insurance for mutual ownership associations. In this case the amortization period is extended to 40 years and the maximum interest rate is fixed at 3½ per cent. It provides "yield insurance" to encourage financial institutions, such as life-insurance companies, to make direct investment in large-scale housing projects. Under the "yield-insurance" system the life-insurance company, for example, is able to earn as an insured minimum a 2 per cent annual amortization rate on its capital and a 2¾ annual yield on the investment in housing projects.

For the low-income groups (rentals under $20) the bill provides for annual federal contributions to help reduce the rents on public housing projects undertaken by local housing authorities. There is also provision for subsidized low-cost rural housing.

In order to encourage private enterprise to aid in the clearance of slums and blighted areas and to promote urban redevelopment, the bill provides aid to local communities for land assembly. Briefly this means that federal and local aid is provided to help

reduce the cost of land to a point at which its re-use for development purposes becomes feasible. These re-use purposes include privately financed commercial developments or housing for the middle and upper income groups, public low-cost housing, and open spaces for parks and playgrounds.

The bill provides for temporary federal loans to localities of 500 million dollars to assist them in getting the land assembly and slum clearance started. It also provides for long-time federal loans of 250 million dollars for a 5-year period, which loans must be repaid in 45 years. In order to accomplish the write-down of the cost of land to its re-use value, the bill provides for federal contributions of 20 million dollars per year to run for not more than 45 years, provided these contributions are matched by the localities. Together, these contributions, it is estimated, would be sufficient to cover about 1.5 billion dollars' worth of land acquisition for redevelopment. It would provide for the purchase of about one-tenth of the slum and blighted land throughout the country. Since the full program provided for in the bill requires 5 years to put it into effect, it would require 50 years to acquire all the slum and blighted land.

While this bill is certainly a major forward step in housing and urban redevelopment, it illustrates vividly the "social lag"—the wide gap between our social institutions and public policies on the one side, and our advanced technology on the other. That a country with the prodigious productive capacity demonstrated in the war can seriously consider taking 50 years to redevelop the slum and blighted areas of its great urban communities is striking proof of the great difficulty of making the necessary social adjustments to changed conditions. Here and elsewhere one begins to see that it is no easy matter for a society to learn how to "live 50 per cent better than we have ever lived before." Yet it would take less than 50 billion dollars of construction, apart from the cost of the land, to rebuild all the slum and blighted areas throughout the country. Compare this with 330 billion dollars expended for war in the fiscal years 1941-1946.

Public Health.

Serious deficiencies, due to inadequate medical care and public-health facilities, have been revealed by the draft record for mili-

tary service. President Truman, in his message to Congress Nov. 19, 1945, stated that about 30 per cent of male registrants between the ages of eighteen and thirty-seven were rejected as physically unfit for service. In addition, of those actually inducted about 1,500,000 subsequently had to be discharged, and an equal number had to be treated while in the armed services for diseases and defects that existed before induction. One-third of the young women who applied for admission to the Women's Army Corps were rejected for physical and mental defects. A large proportion of American children reach maturity with defects and diseases that could have been prevented or corrected at an early age.

The President listed five basic deficiencies and problems with respect to our current health program: (1) the inadequate number, and unequal distribution, of doctors and hospitals; (2) inadequate public-health services and maternal and child care; (3) inadequate provision for medical research and for special clinics for diagnosis; (4) inadequate provision for individual medical care; (5) loss of earnings and consequent family destitution when sickness strikes.

To meet these problems the President made the following proposals: (1) the federal government should provide financial and other assistance for the construction of needed hospitals, health centers, and other health and rehabilitation facilities; (2) expansion of the present federal-state cooperative health programs dealing with general public-health work, tuberculosis and venereal-disease control, maternal and child health services for crippled children; (3) a broad federal program of grants-in-aid to strengthen professional education in medical and related fields, and to encourage and support medical research; (4) a comprehensive system providing for prepayment of medical cost and spreading the risk of sickness over the entire community through the principle of insurance; and (5) the protection against loss of wages from sickness or disability through an expansion of our present social insurance to cover these risks.

Nutrition.

Basic to health is adequate nutrition for the entire population. During the depression of the thirties a large fraction of the population were inadequately fed despite the existence of large agricul-

tural surpluses. During the war agricultural production increased around 30 per cent, of which *increase* only about one-third was shipped to our allies. After taking care of our military forces, the reduced civilian population consumed more food than in peacetime years. Yet food had to be rationed. The explanation for this food shortage is to be found in the greatly increased purchasing power which the war brought to the lower income groups in this country. These people had never before been able to afford a varied and adequate diet.

During the depression some ameliorative measures were started, including the food-stamp plan and school-lunch programs. On June 15, 1945, Senators Aiken and La Follette introduced a bill to provide for improved nutrition and a more effective distribution of the food supply through a food allotment program. Under the provisions of the bill, food allotment coupons would be sold to low-income families on a basis such that the cost of the coupons required to purchase the basic food allotment necessary for a minimum nutritive per capita diet shall not exceed 40 per cent of the family income. In other words, the bill provides, through the coupon allotment system, a method of subsidy to low-income families so as to ensure a minimum standard of food consumption for which minimum it would not be necessary to pay in excess of 40 per cent of the family income. Accordingly, no matter how low the income, a minimum diet would be assured, leaving 60 per cent of the income for other needs.

This proposal applies only to the low-income groups. Adequate nutrition for the whole population depends primarily upon the maintenance of full employment. It is estimated that a full-employment peacetime income would probably bring an increase in food consumption of 18 per cent above prewar standards.[7]

Education.

Finally, perhaps the most serious deficiency of all in this great productive nation is the low standard of educational opportunities for a large proportion of our children. It is precisely in the low-standard areas that families are the largest. Around 40 per

[7] U. S. Department of Agriculture, *Post-war Agriculture and Employment. Miscellaneous Publication,* 562.

cent of all American children grow up in states with intolerably low educational facilities.

A report (1939) of the subcommittee of the Senate Committee on Education and Labor revealed that over 800,000 children of elementary-school age were not enrolled in school at all, mainly for lack of facilities in many scattered rural areas that are impoverished and isolated. The report stated that with approximately 3,600,000 totally illiterate persons there are still more illiterates in the United States than college graduates, and nearly half as many illiterates as high-school graduates.[8] In 1940, of the 75,000,000 persons twenty-five years old and over, there were 2,800,000 who had completed no school years and 7,300,000 who had completed only 1 to 4 years of school. Persons with 4 years or less of schooling are sometimes referred to as "functional illiterates." When put to the test they cannot read a newspaper or write a simple letter. Of the 27,600,000 men of draft age (18 to 44) 1,462,000 had only 3 years of grade school, while 11,446,000 had between 4 and 8 years of grade schooling.[9]

Americans who live in the higher standard states are rarely aware of these facts and indeed regard them as scarcely credible. No other advanced modern nation offers anything like so low educational opportunities to so large a proportion of its citizens.

The explanation for this intolerable situation lies in the fact that the federal government has assumed no responsibility for the education of its own citizens. That is left to each state But many of our poorer states and localities do not have the financial resources to provide even minimum standards. The United States is a country with great contrasts of wealth and poverty in different areas and social groups. In the eight poorest states (1939-1940) the expenditures for education per pupil averaged $39.44 per pupil, while the eight richest states averaged $140.72. Yet many of our poorer states and localities tax their citizens more heavily in proportion to income than do the richer states. In some states, if *all* the state tax money were applied to education (in addition to that now supplied by local governments) they could still not reach the

[8] Report No. 244 on S 1305, 76th Congress, 1st Session

[9] U. S. Bureau of the Census, *The Educational Level of Men of Military Age in the U.S.*, 16th Census, 1940, Series P-9, No. 15, also the *Economic Almanac*, 1943-1944.

average standard of the upper half of the states, leaving no funds whatever available for other purposes. There is no escape from the conclusion that if every American child, wherever he lives, is to be given minimum educational opportunities, federal aid must be forthcoming.

A hundred years ago it was proper enough for local communities to assume the burden of financing the cost of public education. Then most of the wealth consisted of real estate, and taxes were collected largely from property. But this method of financing public education—a function that more than any other concerns the nation as a whole—has become hopelessly obsolete. In a great national economy in which the bulk of the nation's income is derived from business activity, education can no longer be financed largely from local property taxes without, on the one hand, seriously restricting individual opportunities for half the nation's children, or, on the other hand, placing a seriously restrictive burden upon real estate generally and housing in particular.

In 1939-1940 the median state expenditure per pupil was around $85, while the national average was around $105 per pupil.[10] Let us assume that the minimum standard below which no state should be allowed to go is $80 per pupil. If, now, the federal government made grants-in-aid to all states, rich and poor alike, adequate to cover this minimum, that would involve an annual outlay of around 2.5 billion dollars. Richer states, where standards are far above this minimum, would of course finance the difference between the minimum and their own higher standards. But they, as well as the poorer states, would gain relief from unduly burdensome real-estate taxes, as well as increased capacity to provide more adequately for other local services.

A number of bills have been presented to Congress involving very modest sums directed exclusively to provide limited aid to the most needy states. Variable grants are provided based on need and fiscal capacity. But even these proposals have so far been turned down.[11] Thus the nation continues to deny even minimum

[10] *Statistical Abstract*, 1942, p. 134; also Alvin H. Hansen and Harvey S. Perloff, *State and Local Finance in the National Economy*, W. W. Norton & Company, Inc., 1944, pp. 18-19.

[11] See Hearings before the Committee on Education and Labor, United States Senate, 79th Congress, 1st Session on S. 717 and S. 181, 1945. See also Hansen and Perloff, *op. cit.*, pp. 145-151.

educational opportunities to its own citizens. All sorts of obstacles are placed in the way. There are religious objections to federal aid based on fears of central government regimentation. There is the States' rights issue. There is the feeling of many citizens that local communities should finance themselves. This latter argument completely fails to recognize that the counterpart of a nation-wide *market* and a national *economy* is the political responsibility of the nation as a whole for minimum standards for its citizens wherever they may reside. In a highly interdependent national economy, income is drawn from the entire national market. In such an economy the nation as a whole has a national fiscal responsibility.

Thus, again, we are confronted with the difficulty of making the social and political adjustment necessary to "live 50 per cent better" than we have ever lived before. A balanced expanding consumption and rising living standard do not automatically flow from an improving technology.

Chapter XV

Private Investment

PRIVATE capital formation (private investment) may usefully be divided into three categories: (1) plant and equipment, (2) housing, (3) "other," including mainly net inventory changes and net foreign investment.

The "other" items are likely to be of considerable importance in the short run, especially in a highly fluctuating economy. But in a sustained full-employment economy they can be hardly be very significant in the long run. *Large-scale* foreign lending on a sustained basis is neither feasible nor desirable either from the standpoint of the borrowing or lending countries. Some net additions to inventories will, over the long run, be justified by growth in the economy. But the figure cannot be large as a sustained magnitude year in and year out. In the two decades, 1921-1940, the cumulative net additions to inventories aggregated only 7 billion dollars, or about one-third of a billion per annum.

Housing, being consumers' capital, is a special category requiring separate treatment. Its magnitude depends partly on the growth of population, partly on the level and growth of individual incomes in relation to the cost of new houses, and partly upon public policies such as those discussed in the previous chapter relating to such matters as urban-redevelopment programs and mortgage and yield insurance measures of the FHA type.

Investment, Employment, and Productivity.

Private investment in fixed capital—plant and equipment—is not only an important factor in the creation of current aggregate demand; it is also the means by which technological advances can be translated into increased productivity. The continued transformation of the aggregate stock of fixed-capital goods through the process of replacement and renewal and the net additions continually made thereto (activities basic to growth and progress)

create currently not only a flow of money income but also the means of achieving progressively a rise in real income. The process of investment *as such* has the effect only of providing employment, in this respect being like "pyramid building." Once completed, however, the new capital goods increase the productivity of labor.

The "Growth" Criterion for Investment.

Given the savings-income pattern (savings function), a certain level of investment is necessary (in the absence of loan-financed public outlays) to create an aggregate demand sufficient to maintain employment. But this volume of investment may not correspond to the volume needed to take care of (1) population growth and (2) the capital requirements of technical progress.

It would not be sensible to fulfill the requirements of full employment by maintaining a level of investment sufficient to absorb the flow of savings generated at full employment, unless this volume of investment were in fact needed to satisfy the requirements of population growth and technical progress. To do so would be a waste of resources. The "employment" criterion for investment may not correspond to the "growth" criterion (population increases and technical progress). It is the latter that should guide us in our investment policy. If the "growth" criterion does not provide adequate investment to maintain full employment, methods other than an increase in investment should be found to ensure both full and optimum use of resources. The principle of optimum use of resources would be violated if we artificially increased the level of investment merely to provide employment.[1]

Investment Spurts.

The history of the modern economy reveals a tendency for investment during boom periods to outrun the requirement of population growth and technical progress. Modern societies have encountered periodically temporary saturation in investment outlets. Accordingly, every investment boom comes to an abrupt end. The ensuing drop in investment creates unemployment. Put in another way, the amount of investment needed to maintain full

[1] *Cf.* M. Kalecki in *Economics of Full Employment,* Oxford Institute of Statistics

employment has historically far exceeded the amount needed for growth and progress. Yet only in full-employment boom years has the amount of investment been adequate to provide full employment. But this amount of investment could not be maintained continuously without exceeding by far the requirements of growth and progress. This is the essential cause of depressions and unemployment.

Now while it would not be wise policy artificially to increase investment beyond the requirements of growth and progress, it is desirable to make sure that these requirements are fully met. Despite the tendency, as stated, for investment periodically to outrun the requirements of growth, we do not have in any modern society the equipment and facilities (both producers' and consumers' capital) required to take full advantage of modern techniques. This is due in part to failure on the part of private business to replace speedily equipment that has become obsolescent, and partly to inadequate provision for public investment in areas where private investment for various reasons is not feasible.

The Normal Rate of Growth.

In the 20-year period, 1921-1940, gross private investment in business plant and equipment amounted to 8.9 per cent of the Gross National Product.[2] Thus, a gross investment in business plant and equipment of less than 9 per cent appears historically to represent the rate of investment consistent with growth and progress. At peak boom years the rate was 10.7 per cent, but this rate exceeded by one-fifth the requirements of growth and could not continuously be maintained. The *average* ratio of investment in business plant and equipment to Gross National Product could be regarded, however, as a reasonable one. Had it been possible to maintain full employment continuously, the volume of investment required to produce a sustained high Gross National Product would have been *absolutely* much greater than that actually achieved. The continued maintenance of full employment would have raised the level of investment needed to satisfy the requirements of growth and progress.

Equipment represented around two-thirds (69 per cent) of the

[2] About three-fourths of the gross investment in fixed capital was replacement.

total gross investment in business fixed capital in 1921-1940. The most important factors determining equipment investment probably are: (1) sales prospects, (2) inventions, and (3) expectations of a satisfactory profit margin. Accordingly, there are three kinds of public policies that would tend to promote a high level of investment in business equipment: (1) full employment, (2) outlays on scientific and industrial research, and (3) incentive taxation.

The Need for Research.

In 1940 total expenditures, public and private, on scientific research were probably around 400 million dollars per year. Of this total 300 million dollars was spent by private business, about 50 million by our universities, and about 50 million by the federal government, largely for research in agriculture. Yet we spent 2,000 million dollars to develop the atomic bomb.

Scientific and industrial research represents a most important national resource. Recent developments make it abundantly clear that adequate research facilities cannot be provided by private business alone without government support. Many research projects, important for the development of science, lack immediate profit prospects; others require larger funds than private business is prepared to lay out. Finally, there are those that represent no interest for private business; for example, medical research. Yet such research may be no less important for increasing productivity (apart from humanitarian considerations) than industrial research. Federal participation in scientific and industrial research has become imperative.

Patents and Monopoly.

But research would do only limited good if private ownership of patents prevented the adoption of new devices or, through monopoly power, restricted output. All patents owned by the government (except those essential for national defense) should be offered to individuals and business on terms of complete equality. The Office of Custodian of Alien Property has laid down the rule that no patent in its possession shall become the *exclusive* possession of any firm. Equally new discoveries emanating from governmental research should be made freely available to all business. We need, moreover, a reform in our patent laws. The inventor

is entitled to a reasonable reward, but no patent ought to become the basis of monopoly. Free enterprise and competition would be promoted and fostered if all inventions and new processes were made available to any user upon payment of a reasonable royalty to the inventor.

It is encouraging to note the recent arrangement by which the Aluminum Company of America has agreed to grant to the government free use of all its aluminum-production patents. This action was described by the Surplus Property Administrator as "clearing the way for competition in the aluminum industry" and in particular to enable the Reynolds Metals Company to lease and operate two government-owned plants in Arkansas. The patent agreement gives the Reconstruction Finance Corporation free use of the patents for making aluminum from bauxite and the right to sublicense the patents to any company leasing government-owned plants. The Aluminum Company of America had been barred from taking over government-owned plants because of charges of monopoly placed against it by the government.[3]

Incentive Taxation.

A great variety of incentive taxation provisions, tending to promote private investment, have been offered, many of which are impractical. Two such devices, however, appear to me especially worthy of consideration: (1) partial abatement of income taxes on that part of income reinvested in fixed capital, and (2) loss carry-forward for 5 years. The first suggestion has already been discussed in Chap. XI.

The 1944 personal and corporation income-tax law provided for a limited carry-back and carry-forward (2 years each) of business net operating losses, and in addition it also provided for a 5-year carry-forward of all net capital losses. The extent to which investors could utilize these provisions depended upon the availability of other income against which losses could be offset. Here the position of various taxpayers differed greatly. An established corporation or a large-scale financial investor could undertake a risky investment as a side line with the assurance that possible losses would be covered by other income derived from some other line of business. A large corporation could count on the possibility

[3] *The New York Times,* Jan. 11, 1946.

of loss offset as long as the investment in question did not exceed the income that the management was reasonably certain to derive during the period of carry-over. The law thus provided a fair chance for loss offset to large and established business.

New businesses, small enterprises, and small-scale investors were in a much less advantageous position. They are likely to be less diversified and are thus more apt to suffer a net loss in any one year. One venture may result in serious losses and there may be no offsetting profits from other lines. Also a new business, being recently established, has no record of past profits against which current losses could be offset. Thus the law definitely favored in various ways the established, large, and diversified businesses.

Such discrimination is definitely undesirable but it is not easy to avoid it altogether. The heroic thing would be to assume complete loss offsets for all business, new and old, by providing that the Treasury stand ready to share all losses on precisely the same terms in which it shares in profits by reason of income taxation. Yet this kind of approach is probably not practical since there is a vast difference between (1) providing a loss offset for a company which later proves the capacity to make profits and (2) sharing in the losses of every fool venture that overly confident promoters may undertake. The best that can be done, probably, is to provide loss offsets against future profits.[4] This, together with the partial tax abatement on income invested in fixed capital, would go far toward removing any obstacles to investment arising from income taxation.

Some have objected that these incentive devices might stimulate investment in fixed plant beyond a desirable level, thereby creating unused capacity. From the long-run standpoint this is not probable, since once investment has been pushed all around up to the point at which the marginal efficiency of capital as affected by these provisions is equal to the rate of interest, further investment will stop. Excess capacity is rather a function of cyclical and seasonal fluctuations, errors of judgment (which errors would be made with or without these incentives), shifts in location of industry, or in the demand for the special product in question, and the

[4] It is generally believed that the loss carry-back feature is very difficult to administer; it may therefore be desirable to limit the loss offset to future profits.

like. Factors favorable to investment, such as incentive taxation or low rates of interest, merely affect the extent to which the "deepening" process (by which I here mean capital investment per worker) will be carried.

Other Measures.

In addition to the private investment in fixed capital required for growth and progress, a large amount of public investment is also required if full advantage is to be taken of any given level of scientific and technical advance. A part of the gap in capital facilities which would remain if private investment were left to occupy the field alone will in fact be filled by additional private investment once new terrain is opened up by public investment. Thus public investment, thrown in where private investment cannot go, opens up new possibilities for private investment which would not be feasible until basic public projects have been completed. This aspect of the problem we shall consider more fully in the next chapter.

The private investment needed for growth and progress may not be adequate to solve the savings-investment problem. It will then become necessary to meet this problem not by artificially increasing investment beyond the requirements set by growth and progress to the point required to maintain full employment, but by other measures. These include (1) public investment partly or wholly loan financed, (2) shifting the consumption and savings functions by various measures, including, among other things, shifting the tax structure, wage and price policies, subsidization of consumption, and social-security programs, (3) adjustment of the *level* of taxation.

Chapter XVI

Public Investment

NOT infrequently have I encountered the view that adherents to the savings-investment analysis hold that the gap left by inadequate private investment must be filled by loan-financed public investment and that no other solution is possible. This is of course incorrect. The problem can be solved in various ways: by incentive taxation, low rates of interest, and other methods discussed in the preceding chapter to increase private investment; redistribution of income, social security, wage-price policies designed to promote high consumption, progressive tax structure, and other programs to raise the consumption function; and, finally, by reducing tax rates and by substituting loan financing of governmental outlays *other* than public investment projects. It is therefore not necessary to undertake loan-financed public investment in order to satisfy the requirements of stability and progress as stated in the savings-investment analysis or, in other words, to ensure adequate aggregate demand to maintain full employment.

Public Investment and Social Priorities.

Public investment is nonetheless high on the priority list for the reason that many of the gravest deficiencies in our society cannot be met except by a very large increase in the volume of outlays on public-improvement and developmental projects—schools, hospitals, urban redevelopment, slum clearance, public housing, flood control, reforestation, soil-conservation projects, irrigation, hydroelectric power, regional resource development, harbor improvements, river transportation, air-transport facilities, improved highways, streets, recreational facilities including national, state, and local parks and playgrounds, and, finally, facilities for public lectures, music, art, and cultural activities of all

kinds. In the United States we shall not run short of useful and productive public investment projects for a long time.

Moreover, as a practical matter, it is not probable that we could, in the next decade or two, hope to achieve full employment without the substantial contribution that public investment can make. Theoretically it is easy to construct full-employment models without any public investment, and even without any private net investment. But such a model would be defective not merely because it would fall hopelessly short of providing for technical progress, but also because, taking the social structure as it has been developed over the past century, there would in fact be grave *practical* difficulties in achieving full employment without a large volume of investment, public and private.

The Role of Construction.

Consider, for example, the ramifications of construction in the modern economy. The dependence of a vast number of industries upon construction—railroads, steel, machinery, mining, lumbering, etc.—is very great. Without a high volume of construction, public and private, we are in fact not likely to achieve full employment. The distortion, which any drastic decline in this area would cause, would have serious consequences upon the whole economy. It is probable, if we seriously undertake to make good our deficiencies during the next two decades, that we shall wish eventually to move more and more away from the "brick-and-mortar" stage of development toward the *full-consumption* stage of a "circular-flow" society. But this transition will have to be a gradual one. Even so it is not likely that it can then be accomplished unless by that time we have become far more enlightened as a nation than we are today with respect to a great many things, especially fiscal and monetary management.

A Balanced Program.

In the next decade or two, the *practical* problem of maintaining continuing full employment will at best be a very difficult one. We are not likely to succeed if we do not undertake a well-rounded program in which a variety of measures are coordinated and pushed simultaneously. If we rely exclusively on the *investment* approach, we shall fail; but equally we shall fail if we rely

exclusively on the *consumption* approach. And also with respect to the financing of public outlays we shall fail, I believe, if we rely too heavily on either tax financing or loan financing. If we resort exclusively to tax financing, we are likely to be forced, as a practical matter, into so heavy a volume of taxation weighing on mass income and mass consumption that private-consumption outlays will be unduly restricted; if, on the other hand, we rely too heavily on loan financing, we encounter the danger of inflation. As a practical matter, the problem of maintaining adequate aggregate demand commensurate with but not in excess of the requirements of growth and progress is likely to require a balanced program of progressive income taxation together with a moderate volume of loan financing. Such loan financing would permit an increase, beyond what would otherwise be possible, in holdings by the public of savings bonds and savings deposits.

Long-term Financing.

As a matter of practical policy, it is far easier to adjust public thinking to a program of loan financing of public improvement and development projects than to the loan financing of current expenditures. Admittedly public opinion in this respect is not always well advised. Undue emphasis is laid on *tangible* wealth; intangible factors that contribute no less to the productivity of the nation are underestimated. The true wealth of a nation consists not in its physical assets, but in its capacity to produce a high real income. Tangible assets are indeed an essential basis for high productivity, but no more so than the skill, health, and efficiency of the nation's citizens. Current outlays on education and health are surely as sound a "public investment" as outlays on power developments or highways. Indeed, all of the property claims held by the public—whether corporate or government securities—derive their value from the capacity of a society to *produce.* Overemphasis on physical things is a hangover from an earlier period when tangible property was more important than now. Today, more than ever before, intangibles such as scientific knowledge, skills, technical training, personal health and efficiency, social unity, and capacity to cooperate are of prime importance. Programs that contribute to the development of a society that has

these characteristics in high degree are surely even more basic to the promotion of national wealth than mere brick and mortar.

Nevertheless, it is natural that *tangible* assets should continue to give to most people a sense of stability and value. In the formulations of government programs discussed in Chaps. V to X of this book, we have seen, again and again, how important a role these ideas continue to play. Long-term financing of public-improvement and developmental projects can win support while the loan financing of current services, however valuable for productivity, is not politically feasible. It is therefore a convenient fact for practical policy that the volume of public investment needed to meet the requirements of growth and technical progress is in fact very large in all modern countries, and especially in the United States. The plain fact is that the needed volume of useful and productive public and private investment is more than ample to provide loan expenditure outlets for the flow of savings seeking investment. Indeed, to prevent aggregate demand from becoming too large, a part of the needed public investment will probably have to be tax financed. As a practical matter, therefore, it is probably not necessary to apply long-term loan financing (apart from the cycle) to projects other than permanent improvements.

Capital Financing and the Money Supply.

At this point a slight digression with respect to loan financing and monetary policy will, I think, be useful. In a dynamic society experiencing growth and progress, the maintenance of full employment involves a continuing increase in real income. If the price level is substantially stable (value of money constant), this means also a rise in *money* income proportional to the rise in *real* income. If, on the other hand, the gains of growth and progress were taken out in lower and lower prices, total money income would remain constant, while real income would rise. But the *maintenance* of a full-employment income in a growing society with improving techniques means a *rising* money income if the general price level is kept reasonably stable.

Consider now the savings-investment relationship (1) under a *constant* money income, and (2) under a *rising* money income. Under "investment" we include here all offsets to savings—public loan expenditures as well as private investment. Utilizing the pe-

riod analysis of Professor D. H. Robertson, saving[1] and investment (measured in money terms) are in equilibrium only when money income flows on at a constant level. If income rises, investment exceeds saving; if income falls, saving exceeds investment. However, in the statistical sense (ex post) used in estimates of the component parts of the Gross National Product, saving and investment are always equal. Saving and investment are also always equal in the "logical" or "mathematical" formulation of Keynes.

In a full-employment society (with improving techniques and a growing labor force) income must rise if the value of money is kept stable; or, in Robertsonian language, investment will exceed saving. In other words, saving from the disposable income earned yesterday (Robertson's "saving"), in a growing full-employment society, must be less than the realized saving springing from the higher income earned today (saving in the statistical or ex post sense). If "realized saving" exceeds "disposable saving," the difference must have come from idle money or new money.[2] Investment will always equal "realized saving," and that part of "realized savings" that is not "disposable savings" flows from the injection of new money or idle money (M or V) into the income stream. If the MV of today is higher than the MV of yesterday, there must have been an increase in M or V or both. Thus the difference between investment and "disposable saving" (which indicates a rise in income today over yesterday) is represented by an increase in MV. In other words, the excess of investment over "disposable saving" was financed by an increase in M or V—new money or the activation of idle money.

All this amounts to the same thing as saying that, if the income velocity of money remains constant, the money supply (M) will rise in direct proportion to increases in output. If this occurs, money income will keep pace with real income. But a rise in money income in proportion to increases in output may quite as well be accompanied by a change in V while M remains relatively constant. It is the change in the *flow of money income* that is significant. How that change reveals itself in terms of changes in M

[1] By "saving" is meant, in Robertsonian language, that part of disposable income (earned yesterday but disposed of today) which is not spent on consumption.

[2] "Money" is here used in the broad sense to include (1) demand deposits and (2) currency.

or *V* is itself of no great importance. It is important, however, that the money supply (*M*) shall increase sufficiently in a growing society to provide liquidity adequate for the maintenance of a low rate of interest.

The essential point about the above discussion is that in a growing society, investment (including government loan financing) must continually outrun "disposable saving." This at any rate is true if we wish the money income to keep pace with increasing real income. The excess of investment over disposable saving, or in other words the rise in money income, requires in general an expansion of bank credit. If this does not take place through increased bank investment in private securities or through commercial loans, then it would have to be implemented through new issues of government obligations to the banks.

Assuming that the required increase in the money supply is brought about by an increase in bank holdings of *private* loans and investments, an expansionist and developmental fiscal program involving large outlays on public investment could be wholly tax financed or loan financed from issues sold to the nonbank investors.

A tax-financed expansionist program would, however, require larger public outlays to achieve full employment than one partially loan financed. If more of the income stream is taken in taxes, less will be available for private-consumption at each national income level. Accordingly, public outlays must constitute a larger component part of a full-employment Gross National Product. If these public outlays are entirely tax financed, such taxation will cut into the consumption and saving. Large public outlays, tax financed, will change both the consumption and the saving function.

Thus an expansionist and developmental public investment program does not necessarily involve long-run loan financing.[3] It is probable, however, that, given the conditions that are likely to confront us after the postwar restocking boom is over, it would be wiser for us to loan-finance some considerable part of the public-

[3] The term "deficit financing," while technically correct, connotes a social loss. But long-term capital financing of public projects that raise the productivity of the community, whether by improving its human or its material resources, can surely not be regarded as involving a social loss even though "deficit financed."

improvement and developmental program which it will be necessary for us to undertake. A reasonable degree of loan financing will offer outlets to our savings and would, I think, fit our established institutional arrangements better than the more drastic program of financing the whole from taxation. There will be differences of opinion as to how much should be financed from taxation and how much from borrowing. But, I repeat, it can all be tax financed if this policy is deemed on balance the desirable one, despite the disadvantages referred to above.

Adam Smith on Public Investment.

Adam Smith laid down the excellent principle that it is the duty of the sovereign or commonwealth to erect and maintain "those public institutions and those public works, which, though they may be in the highest degree advantageous to a great society, are, however, of such a nature, that the profit could never repay the expense to any individual or small number of individuals, and which it therefore cannot be expected that any individual or small number of individuals should erect or maintain." [4]

This principle as here stated is amply broad enough to include such projects as the TVA, urban redevelopment, slum clearance and public housing, educational and public health facilities, and the like.

Three conditions are involved in this principle. Each explains why certain projects can be undertaken *only* by the government. First, some projects, whether by reason of magnitude or risk, cannot be undertaken by private enterprise even though they might in the end prove to be self-liquidating or even highly profitable. There is a prospect that the TVA and possibly the Columbia Valley projects will fall into this category. Second, some projects in the nature of the case cannot be expected to yield a return covering the direct cost, yet are nevertheless genuinely profitable in the sense that they enlarge total national income by an amount at least equal to their cost. Third, some projects contribute very little to "Gross National Product," yet in terms of cultural and social values they are deemed to contribute to "well-being" sufficiently to justify the "cost" in terms of productive resources devoted to these activities. The former two are theoretically capable

[4] *Wealth of Nations,* Book V, Chap. I, Part III.

of statistical measurement though in practice accuracy or precision is often difficult; the third represents a value judgment entered by the community as a whole through democratic processes.

The first and last conditions are, I think, widely accepted and offer little difficulty. The second condition, however, has not been adequately recognized or appraised. Admittedly the principle involved is a difficult one in practice. What is the over-all effect of a certain governmental development project upon Gross National Product? This is often not easy to estimate. But we have no right to turn a project down until we have made the attempt. The comparative approach is often useful. It will not be difficult in some cases to see that, with respect to a certain project that brings no direct return to the Treasury whatever, the over-all effect on the magnitude of the Gross National Product is far greater than that of another project involving the same outlay, which cost, however, is directly reimbursable to the Treasury. The realizable *direct* return is in fact not of great importance for correct social accounting. In all cases, whatever the reimbursable returns may be, the valid economic consideration should be: What is the over-all net addition to Gross National Product from this project in relation to its cost? If this fundamental principle were firmly grasped, we should have much less emphasis than is now placed upon "self-liquidating" projects. A good example is a free public road, which is clearly not self-liquidating but nonetheless productive in a very real sense.

Indeed, if a project is clearly "self-liquidating" in character, rigorous adherents of private enterprise should oppose such a project for public investment. If it is clearly self-liquidating (and of a size that is manageable), it could and should be undertaken by private enterprise. Self-liquidating projects of a magnitude so vast as to be unsuitable for private enterprise, or involving the assumption of great risk in a single venture, are appropriate for public investment and can be undertaken only by government. Thus it is not true that self-liquidating projects are *never* suitable for public investment. Nevertheless, the point does need stressing that typically truly self-liquidating projects ought in general to be suitable for private enterprise. It is, however, especially projects that are not *directly* self-liquidating projects—projects which nonetheless contribute to over-all Gross National Product an amount

equal to or in excess of cost—that are appropriate for public investment. In the nature of the case, they cannot be undertaken by private enterprise, yet without them we should not be able to take full advantage of the level of productivity made possible by technical progress.

There is an intermediate sense in which the concept of "indirect" productivity may be applied. This does not refer to the overall addition to Gross National Product viewed from the standpoint of society as a whole but it refers to the net increase in Treasury tax revenue springing from the effect of the project on Gross National Product. In this narrower sense, a public investment project might be "profitable" to the Treasury, even though there were no directly reimbursable returns at all. Thus many non-self-liquidating projects are nonetheless a good "business proposition" for the Treasury. While this consideration is important, nevertheless a broader view is needed. Projects should be judged not by whether they are "good business" for the Treasury but by whether or not they are "good business" for the economy as a whole. The intermediate concept is, however, useful since it helps to disclose how utterly restricted is the view that public investment projects are not defensible unless they are directly "self-liquidating."

Volume of Public Investment.

In the high construction years 1926-1930, public construction, federal, state, and local, averaged only 2.4 billion dollars. In the Full Employment Hearings Major General Fleming, Administrator Federal Works Agency, offered the opinion that a 5-billion-dollar public construction program (*i.e.*, publicly financed) was feasible. This would represent a large growth in the public investment. The question is whether even this is not based on an inadequate recognition of the needs of a society capable of producing from 180 to 200 billion dollars of goods and services annually (1946 to 1950) at 1944 prices. We need a 10-year program of school construction to replace obsolete and substandard schools in all parts of the country, but especially in educationally backward states and to keep abreast of population shifts and changes.[5] We

[5] See U. S. Office of Education, *Planning Schools for Tomorrow*, Leaflet No. 64 (1942); the Advisory Committee in Education, The Land-grant Colleges, Staff Study No. 19 (1939), National Resources Planning Board, National Resources Development, *Report for 1943*, Part I, p. 73.

need a 10-year program of construction of hospitals and public health facilities.[6] These together would require at current building costs about 1.5 to 2 billion dollars annually. The Federal Housing Agency has suggested a program of house construction for the first decade after the war of 1,260,000 units per year, for which 360,000 units are needed at rentals below $20 per month. At this rate we should be able to replace in a decade only 3,600,000 of the 6,800,000 slum and substandard houses disclosed in the 1940 Housing Census for which the median rental was less than $14 per month. Such a program would involve an annual outlay on construction of about 1.5 dollars per annum. A reasonable minimum figure for public construction related to urban redevelopment (apart from land purchase) including port developments and airports is around 500 million dollars per annum. Regional Resource Development, including soil conservation, flood control, waterways, reforestation, national and state parks require around 1.5 billion dollars annually. Outlays on local and interurban highways, especially express highways through and around our great metropolitan centers, bridges, streets, etc., will require around 2.5 billion dollars per annum. All this adds up to around 7 to 8 billion dollars per annum of public construction, federal, state, and local.

In the decade 1921-1930 new construction, public and private, amounted to 10.8 per cent of Gross National Product. If construction were to make an equal contribution to a postwar GNP of 180 billion dollars, that would be 18 billion dollars of new construction.[7] Private housing might average for some years around 6 billion dollars, business plant 4 to 5 billion dollars. This would leave 7 to 8 billion dollars for publicly financed construction.[8]

[6] See Alvin H Hansen and Harvey S. Perloff, *State and Local Finance in the National Economy*, pp. 174-180.

[7] The Construction Industry, National Planning Association, suggest a postwar construction goal of 22 billion dollars including maintenance, or 18 billion dollars new construction.

[8] Eight billion dollars would represent 5 per cent of a Gross National Product of 180 billion dollars. This happens to be precisely the per cent which Professor Copland suggests for Australia and which he thinks "could hardly be considered as too much or as economically unsound."

Construction Stabilization Bill.

In October, 1945, a Construction Stabilization bill (S. 1449) was introduced in Congress representing in large part the recommendations of the House Special Committee on Postwar Economic Policy and Planning as embodied in its Report on Postwar Public Works and Construction. The bill provides, among other things, for the establishment of a Public Works Stabilization Committee composed of ten members, consisting of (1) four federal officials including the Federal Works Administrator (who would serve as Chairman), the Chief of the Army Engineers, the Commissioner of Reclamation, and Director of the Bureau of the Budget; (2) six state and local officials, two representing the states, two the municipalities, and two the other political subdivisions.

Each government agency responsible for a construction program would be required to prepare and keep up to date a 6-year program of public works, part of which should be fully planned and ready to put into execution on short notice. The Public Works Stabilization Committee would have the responsibility to review these projects and report to the President a consolidated program and estimates. Plans and programs of the states and localities would also be collected. Federal advances (for which the bill provides 150 million dollars as a permanent revolving fund) for planning would be made to states and localities in order to assist them in building up a 5-billion-dollar reserve of planned public works.[9]

[9] In a Report to the Federal Works Administrator on *Timing of Public Works Construction as a Measure for Stabilizing the Construction Industry* by the Public Works Construction Advisory Committee, Nov. 6, 1945, it is suggested that public works might average 5 billion dollars per annum of which 2.5 billion would be federal.

"It is reasonable to consider," the report stated, "that the volume of federal public works during a depression might be increased to double that carried on during national prosperity."

On the basis of this suggestion, a range from about 3.5 billion dollars of public works (federal, state, and local) in boom times to 7.0 billion dollars in depression periods might be feasible. If, now, private construction could be held within a range of, say, 12.0 billion dollars in boom years to 7.5 billion dollars in depression years, a high degree of stability in construction as a whole, public and private, would be achieved.

The advisory committee was on the whole rather skeptical, but an examination of the data contained in their report reveals that the possibilities are somewhat greater than there envisaged.

PART FIVE

A CRITIQUE OF SOME CURRENT PROPOSALS

Chapter XVII

Underwriting Private Consumer Expenditures[1]

THE view is widely held that underwriting private consumption would ensure full employment. But this is not correct. That this misconception widely prevails is quite understandable. On the surface it appears reasonable that the maintenance of consumption will also maintain full employment. If consumers' goods industries are kept going at normal capacity, will not in-

[1] An able and comprehensive statement on this problem may be found in John H. G Pierson's pamphlet, "Full Employment in Practice," Institute on Postwar Reconstruction, New York University, 1946 While there is very much in the pamphlet that is admirable and well balanced, I do not think his proposal that the government should undertake a rigorous commitment to underwrite private consumption expenditures from year to year is practical. A rigorous commitment of this character, if undertaken, is likely, I feel, to involve the government in procedures that would discredit the plan. "The reed that does not bend breaks" is a wise adage that applies also to full-employment policies. As I see it, Pierson does not adequately appraise the role of fluctuations in private capital outlays, and he minimizes the importance of a vigorous *compensatory* offsetting program His proposal to underwrite private consumption is on the one side inadequate (as I believe he would himself admit) and on the other side so rigid that it would, I think, be discredited if seriously undertaken. Finally, apart from some policies upon which there would be general agreement, he is extraordinarily vague about how in practice this established level of consumption is, in fact, to be rigorously maintained. The only way in which I can make his "insurance" really mean anything would be for Congress to undertake a rigorous commitment to issue money outright to consumers in sufficient volume to maintain consumption expenditures at the desired figure. But in fact he stops short of this extreme proposal and has not, so far as I know, advocated it. The nearest he comes to that procedure is his advocacy of remission of taxes.

There is in his work, I feel, a vague reliance on the belief that if the "insurance idea" were *proclaimed* by Congress, business and consumer expenditures would automatically prove adequate. It is, I feel, never explained just how the insurance commitment is to be rigorously fulfilled. Perhaps I have failed to understand the proposal.

vestment be maintained also? And so the whole thing, it is said, rests on consumption. In point of fact, however, a large part of investment is of an autonomous character and has no relation to the level of consumption. For example, investment in cost-reducing machinery is of this type.

Now it is indeed true that measures designed to maintain consumption will prevent much of the cumulative decline which automatically tends to develop in a depression. It will lift the "bottom" at which the decline will stop. It will place a cushion under the depression.

But underwriting consumption will not provide full employment. The belief that it will is based on an inadequate conception of the factors on which full employment, in all modern societies, is based. It fails to recognize the dynamic role of investment and savings. It fails to take cognizance both of the technological basis of new investment and of the customs and habits underlying the propensity to save.

Consumption and Total Outlay.

The mere maintenance of private consumption expenditures will not provide full employment, simply because in no advanced community do these outlays constitute more than a fraction (though a large one) of the aggregate expenditures. Thus in the United States in the relatively high income years, 1923, 1926, 1929, and 1937, private consumption outlays constituted each year only 71.2 per cent of the Gross National Product. If nothing were done to secure high activity except to *maintain* private consumption, we should fall in the usual case about 30 per cent short of full employment.

A part of the remainder is government outlays. And if they were also maintained, that would help. But there would still remain the gap left from any decline in private investment. This constituted in 1921-1930 about 16 per cent of Gross National Product. Whenever any decline occurs here, *offsetting* outlays must be made if employment is to be maintained. Nor is this enough, since total outlays must continually rise to take care of growth and increasing productivity. Accordingly, if private in-

vestment declines, either private consumption expenditures must be increased, or public outlays, or both. But this requires something more than the *maintenance* of consumption. Compensatory fiscal policy will be required, whether in the form of tax reduction or increased public outlays.

Consumption and Investment.

This conclusion will be denied on the ground that the maintenance of private consumption would itself prevent a decline in investment. But this is not the case. The mere maintenance of private consumption, or even of the total income level, would not require any *net* investment whatever; only replacement. And since in fact, under modern business practices, some part of replacement investment serves to improve and expand productive capacity (not merely to *maintain* it) even replacement investment outlays would decrease somewhat if there were no growth and expansion. Net investment is largely of an autonomous or spontaneous character, related to growth and advances in technique. Every period of high investment is one in which the economy is moving forward into a new frontier of technical progress.

Motivation.

There remains the fact that it is not practical to underwrite private consumption *fully*. To do so would divorce reward too far from production. This is not feasible in practice. There is a difference between fully underwriting consumption and establishing *minimum* standards of consumption for all citizens whatever misfortunes may be encountered over which they have no control, such as sickness, accident, unemployment, old age, and inequalities of opportunity suffered by the underprivileged born into an unfavorable social and economic environment. To this latter goal modern democracies are committed, but nowhere has it yet been satisfactorily met. Minimum standards are everywhere too low. But they *could* be set too high. The *full* underwriting of consumption would remove financial incentives to effort and efficiency. It is not a practical program. Some margin is necessary between minimum social standards and efficiency wages.

The Cumulative Process.

If nothing is done *except* to underwrite consumption, it is impossible to escape not only a decline in income (when autonomous investment is temporarily exhausted) but also some part of the cumulative downward process. A compensatory program is therefore necessary.

Recently some economists have inclined to the view that a program of full employment would itself tend to stabilize fully the rate of private investment. This view is correct to a certain degree. If we achieved stable full employment, the fluctuations in private investment would indeed be far less. But this relates only to the cumulative process. The *induced* decline in investment could be avoided. This would represent a major gain. Under a program of sustained expansion and development, the character of the business cycle, as we have known it in the past, would significantly change. Fluctuations in spontaneous or autonomous investment would be reduced but not eliminated. But all this involves an active compensatory program. A program limited to the underwriting of consumption to the extent feasible would fall far short of ironing out or offsetting investment fluctuations. These, in turn, by causing unemployment, would induce a further decline. And so the cumulative process once started might spread (however gradually under the maintained minimum) until there was considerable unemployment.

Accordingly, full employment could not be maintained except (among other measures) by the active use of a compensatory program. Now if under such a policy full employment *is* maintained, then private consumption outlays would in fact be sustained. But this is a result and not the cause of full employment. Of course the result in turn becomes a cause. Any success gained toward the goal of full employment becomes self-sustaining in part. A compensatory tax program, for example, would help to sustain full consumption by increasing the "take-home" pay. This might help greatly to prevent any decline in total private consumer outlays provided *other* compensatory measures were also taken to offset spontaneous fluctuations in investment.

A Practical Consumption Program.

A practical program to underwrite consumption involves adequate social-security and social-welfare measures, public health facilities, food subsidies, low-cost public housing, public recreational facilities, minimum educational standards everywhere, family allowances, supplemental farm-income payments, minimum-wage laws, and as far as possible a guaranteed annual wage.

Chapter XVIII

Interest-free Financing

CURRENTLY there is renewed attention being paid to proposals to resort to interest-free financing of public expenditures. The large increases in the public debt which all modern governments have experienced doubtless explain in large part this tendency. Resistance to high taxes is a natural reaction. The effects of a large interest-bearing public debt upon the economy are varied and somewhat complicated, and the simple and unsophisticated view (often a convenient one for political purposes) is likely to be that such a debt is an unmixed evil. As we shall see in a later chapter, this is far from being correct. But it is a widely held dogma. Neither is it true that taxes are an unmixed evil. Without taxation, under conditions such as modern countries face, we should suffer serious consequences. It is not possible to view either taxes or the public debt in a vacuum; both have to be considered in relation to economic circumstances.

Money vs. Interest-bearing Debt.

Since taxes and burdensome interest-bearing public debt are regarded as undesirable, it is not unnatural to seek other methods of financing the necessary and desirable public outlays. Indeed, if other methods could be found that are better than taxation or the issuance of interest-bearing obligations, they ought to be used. There is only one other way, so far as I know, of government financing, and that is through the issue in one way or another of *new money*.

Coinage of money is not a means of financing public outlays. When a government coins money it only places an official stamp upon precious metals that citizens bring to the mint. New money is indeed created, but it is not issued by the government as means of paying for government purchases. When, however, the government issues paper money, it may do so in exchange for goods and

services purchased, as was the case with the "greenbacks" issued in Civil War days. But governments (for example, some of our colonial governments) may also issue paper money to merchants, manufacturers, and farmers as a loan based on mortgages or other collateral. In this case the government is conducting a kind of banking business. The money supply is increased, but not as a result of government spending.

Under modern conditions, the money supply consists mainly of demand deposits (bank-check money) and to a lesser degree of currency (pocketbook money). Coins are used only for small change, and currency consists mainly of notes issued by the central banking system—in the United States, Federal Reserve notes. Thus modern governments do not usually issue paper money.[1] Demand deposits are created by the expansion of commercial bank credit, and demand deposits may readily be converted into currency if so desired.

Demand deposits may be increased through (1) the extension of credit (loans) to individuals or business firms by commercial banks, (2) the increase in the investment of commercial banks in mortgages or private securities, and (3) the increase in the investment of banks in government bonds. Thus the increase in interest-bearing public debt *may* cause an increase in the money supply (demand deposits). Such increase will occur if the government sells its bonds to commercial banks.

The 100 *Per Cent Reserve Plan.*

Now it has been suggested that the power which commercial banks have to create demand deposits should be disallowed in the future. One way of doing this would be to introduce the 100 per cent reserve plan. This would require all banks to hold a reserve of currency, dollar for dollar, against all their demand deposits. Commercial banks would then no longer be able to exchange their own credit for loans and investments. In other words, they could no longer make loans or investments simply by issuing

[1] In the United States, there are still some $347,000,000 United States notes (greenbacks) outstanding. In addition other forms of Treasury currency outstanding are silver dollars, silver certificates and Treasury notes of 1890, subsidiary coin, and unretired Federal Reserve Bank notes and National Bank notes.

their own credit (that is, crediting their customers on the books with a demand deposit). Banks would thus no longer be permitted to "create money." If someone brought currency to the bank, a deposit could be created against this currency. If a depositor wanted currency, he could always get it because the bank would always hold currency back of every dollar of deposits. If he wanted to write checks against his deposit account, that would only *transfer* the deposit to someone else. The banks would hold currency, dollar for dollar, back of all demand deposits. People would continue to hold demand deposits (as well as currency) because payment by check is often more convenient (and safer) than payment by currency.

Now what has all this to do with interest-bearing debt? Very much. For one thing, the transition to a 100 per cent reserve would be made by the federal Treasury issuing currency to the banks in exchange for government securities until the currency holdings of the banks (plus their present cash reserves) would equal total demand deposits. Thus, for example, the total demand deposits (excluding interbank deposits) of all member banks, on June 30, 1945, amounted to 81.1 billion dollars. These banks held cash (including reserves with Federal Reserve Banks) amounting to 16.0 billion dollars. They held 73.2 billion dollars of government securities. Accordingly, if the government exchanged 65.1 billion dollars of newly issued Treasury currency (United States notes) for an equal amount of securities, the banks would hold 81.1 billion dollars of cash (currency plus reserves at the Federal Reserve Banks) against an equal amount of demand deposits. Thus, at one stroke the interest-bearing debt of the government would decline by 65.1 billion dollars.

That looks, at first glance, like a miraculous and painless way of getting rid of a large part of the interest-bearing public debt. But on reflection it will soon appear that it is not quite a way of "getting something for nothing." The banks would lose 65.1 billion dollars of earning assets yielding an annual return of around one billion dollars. The banks perform an important and essential public service in supplying the country with a convenient and efficient means of payment—the checking system. This involves billions of transactions and an expensive system of records and accounts. This service has to be paid for somehow. The cost is

now covered in large part by interest earned on government bonds. If the 100 per cent reserve system were introduced, these interest receipts would be lost to the banks. True, the banks could cover their costs (plus reasonable profits) by making service charges. The public would then be paying for these services in another way. But the decline in the public debt is clearly not a *net* gain. We are not getting something for nothing.

Would service charges (about 10 times what they now are) be a more equitable way to pay for the checking service? I do not think so. The modest service charges now levied are already very unpopular. They are regressive on the small depositor. They are in effect a regressive form of taxation for a vital public service. Heavy service charges would drive small depositors away from the use of checks. Yet, this medium of exchange ought to be fostered, not discouraged. The checking system is an important part of the modern market economy. It ought to be as entirely free from special service fees as are free highways.

If it is argued that bank earnings are now excessive, that is a different matter and can easily be taken care of either by special regulations with respect to the type of bond holdings available to banks, or else by special taxation. Thus, the public debt held by the banks may be said to be burdenless on the community in the sense that the cost of the checking (and related bank) services has to be covered somehow or other. Accordingly, I am not impressed with the alleged advantages of the 100 per cent reserve scheme as a device to reduce the interest-bearing public debt.[2]

But now the 100 per cent reserve schemes would not only be a means, at the time it was first introduced, of retiring a large part of the public debt. It would also be a means of financing such part of public outlays as might seem appropriate without resort to taxation or borrowing from the public. Followers of this plan in general tend to oppose compensatory public spending as a means to overcome depressions. They do not wish to vary public outlays countercyclically. Whatever public expenditures are

[2] I cannot here enter into a discussion of other effects of the 100 per cent reserve plan—the fundamental change it would make in the role of the banking system in a private-enterprise economy and the general merits and demerits of the scheme as a whole. See, however, my discussion in *Full Recovery or Stagnation,* Chap. V.

agreed to as necessary and desirable should be stabilized or allowed to increase secularly as needed. If, now, a depression begins to cumulate, taxes should be reduced either by raising the exemptions on income tax or reducing rates or both. The deficit thus created should then be financed by the issue of new Treasury currency. This currency for the most part would not be wanted by the public. They would deposit it at the banks and receive in exchange demand deposits. Increased liquidity all around would stimulate investment and consumption, it is assumed, until the depression is finally overcome.[3]

Not all followers of the 100 per cent reserve scheme favor the compensatory tax policy outlined above. In general, they tend to favor a policy of "open-market operations" by which variation in the money supply is used as the main countercyclical device. If a depression begins, the government should start to buy up government bonds held by the public, paying for them by the issue of new Treasury currency. This currency, for the most part, would be deposited in the banks and bank deposits would rise. This process should be continued until the public became so saturated with money that sooner or later private investment and consumption expenditures would rise.

Currency and Consols.

Some adherents to this policy would wish to eliminate the multiplicity of government security issues now found in the market. Simons and Mints have advocated simplification of the whole procedure by substituting consols (perpetual bonds) for the current array of issues ranging all the way from short-term Treasury bills to long-term bonds. The government would then have three methods of financing: (1) taxation, (2) currency issues, (3) sale of consols. In a serious depression large new currency issues would be made, not only to cover the deficit created by tax reduction, but also to pay for large purchases of consols from the public. Financing the deficit and purchasing consols, both together, would

[3] This, as I understand it, is one aspect of the program by Simons and Mints. See Henry Simons, "Federal Tax Reforms," *International Postwar Problems,* January, 1946; "On Debt Policy," *Journal of Political Economy,* December, 1944; "Debt Policy and Banking Policy," *Review of Economic Statistics,* May, 1946. See also Lloyd Mints in the last-named issue.

flood the country with liquidity designed to produce recovery. On the other hand, an inflationary boom would be restrained by reversing these policies. Excess cash in the hands of the public would be mopped up (1) by lowering tax exemptions to the normal level and restoring tax rates and (2) by selling consols to the public, thus mopping up much of the cash held by the public. This would tend to put a stop to excess spending.

Under this plan interest-bearing debt (consols) would be increased in boom years and reduced in depression years. Borrowing (issue of consols) as an anti-inflation measure would be used as a means to mop up excess cash. Repurchase of consols (debt retirement) would be invoked as a depression remedy—a means to put more cash into the hands of the public.

All this sounds a little strange to our ears, since we are accustomed to the idea of borrowing in depression years to finance recovery. It is true that we are accustomed (at least in wartime) to the idea of selling bonds to the *public* as a means of mopping up cash and reducing private spending. The paradox is, however, easily cleared up. Borrowing, as it is actually practiced by modern governments, is of two kinds: (1) borrowing from *banks,* which increases the volume of demand deposits, and is therefore expansionist in the respect that it increases the cash holdings of the public and so adds to their spending power, and (2) borrowing from the *public,* which, if the funds are spent by the government, activates funds which may previously have been held idle. If, however, the government borrows from the public in boom years, thus taking *active* funds out of the market, and uses these funds to retire bonds held by the banks, this combined action has the effect of reducing the money supply (cash holdings) and curtailing private expenditures. If in addition taxes are also used to mop up deposits held by the public, and these funds are used to purchase bonds held by banks, curtailment of private spending would be still more drastic.

Under existing practices borrowing from banks has an expansionist effect similar to the Simons-Mints issue of currency. Borrowing from the public has a contractionist effect if the funds are taken from active private use (as in boom periods) and used to retire bank holdings; borrowing from the public, however, has an

expansionist effect if drawn from idle funds and put to active use by the government.

This latter use is not resorted to by the 100 per cent reserve adherents, since they prefer to finance by the issue of currency. Thus they wish to resort to borrowing only in boom years, and to retire debt only in depression years. If on balance depression tends to predominate, this condition would favor a rapid retirement of the public debt. But, on the other side, this condition would cause a rapid increase in the cash holdings of the public. Eventually, if the debt were entirely paid off, the property claims held by the public in the form of earning assets would proportionally decline while liquid nonearning assets would rise.

Monetizing the Debt.

Taxation, it is argued, should be adequate (1) to prevent inflation, (2) to finance any desirable level of federal activities, (3) to service the debt, and (4) to retire outstanding debt rapidly. But this statement seems to require some qualifications and perhaps amendment according to the analysis made. Reliance is not merely on taxation but also on the sale of consols (increase in debt) to mop up excess private funds in inflationary periods. In depression periods tax exemptions are to be raised and tax rates reduced. Finally, taxation would not be high enough to reduce outstanding debt except in boom years, but in such years debt should not be retired (à la Mints) since such retirement would put cash holdings back again into the hands of the public.[4] In the Simons-Mints scheme debt could thus be retired only in depression, and then not by taxation but by the purchase of bonds with cash. In this event debt retirement would always involve a corresponding increase in the cash holdings of the public. If, however, in each boom taxation alone (not the sale of consols) were relied upon to mop up excess cash, while in depression periods debt retirement were used mainly to increase liquidity (new currency would be issued against purchased bonds and not to finance a deficit), then debt retirement could secularly be achieved. But then compensatory fiscal action would be weakened not only by

[4] Under the 100 per cent reserve scheme, the banks would hold virtually no government interest-earning debt. Accordingly it would not be possible to use the excess tax money to retire bonds held by the banks.

the policy of opposing increases in public outlays in depression periods but also by reluctance to create a deficit. With these qualifications, debt retirement, under this proposal, could be accomplished in one of two ways: (1) taxation and (2) monetization of the debt.

Novel Procedures vs. a Flexible Fiscal Policy.

What conclusion can we reach about these proposals? First, it should be noted that they represent violent departures from the established practices of all modern governments. This is by no means necessarily a valid argument against their adoption. Progress cannot be made without adapting institutions to changing needs. This I have myself argued again and again. But *drastic* change in social institutions is not in itself a desirable end. Moderate adaptation of established procedures is much to be preferred to a violent break. The difficulties involved in social progress are great enough anyway. It is usually (though not always) better to build on what we have than to start something entirely new. Unless, therefore, it can be shown that the radically novel procedures of the 100 per cent proposals are superior to quite feasible adjustments of established practices, there is no good reason for their adoption. I do not believe that these proposals are necessary, nor do I believe that they are as effective or as workable as the methods of "orthodox" [5] compensatory fiscal policy.

Compensatory fiscal policy, as the phrase is commonly used, has the great advantage that it involves no new procedures. It involves only a rational and deliberate use, for purposes of stability and full employment, of the established procedures and practices of all modern governments. There are no novel or "panacea" reforms necessary. Governments will continue to spend for useful and productive purposes, to tax, and to borrow through familiar channels. These activities are, however, directed and integrated by a conscious purpose toward a deliberate end. The powerful fiscal activities of government are not allowed to operate so as to produce instability and unemployment. Such a program is not

[5] It is perhaps no exaggeration to say that "compensatory fiscal policy, as it has come to be used in recent years, has by now become the 'new orthodoxy.'" The announced government programs discussed in Chaps. V-IX perhaps justify this suggestion.

only within the reach of practical politics; it has already arrived. It is in line with evolutionary development.

Defects in Proposals.

There are, however, I believe, fundamental weaknesses and defects in the general proposal we have been discussing as a monetary and fiscal device to achieve stability and full employment. To begin with, this general approach in part misconceives the nature of the cycle and the more general problem of underemployment; in part it underestimates the strength of the factors making for depression. And it vastly overemphasizes the efficiency of mere increases and decreases in the money supply.

"Investment," said Simons, "is largely a matter of the fundamental security of property, including security against monopolies, labor and other."[6] This statement fails to take cognizance of classical analysis of the factors underlying investment activity together with the analysis of business-cycle theories during the last 50 years. It is of course true that the modern market economy cannot function without law and order and a reasonably free price system. But this necessary condition does not explain the volume of investment or fluctuations in investment. It takes no cognizance of the role of growth and technical progress in the process of capital formation.

The boom is essentially a period in which the "bucket" of capital formation (having been enlarged by new advances in technique, new discoveries of natural resources, and population growth) is being filled up by a spurt of investment. The speed of this process in every boom period exceeds by far the normal rate of growth for reasons elaborated by many business-cycle theorists, including particularly Schumpeter, Pigou, Spiethoff, Aftalion, Robertson, and others. When this spurt of investment has gone on for some time, a temporary saturation is reached. And this saturation may be reached before recovery has proceeded to the point of full employment. That depends upon how much the "bucket" has been enlarged, how rapid the advance of technique. In the twenties the burst of new industries related to the rise of the automobile age was a significant factor making for a vigorous and prolonged boom. Once the plant and equipment had been

[6] "On Debt Policy," *Journal of Political Economy*, December, 1944.

built up to the requisite level, there was obviously no point in rebuilding the capital facilities all over again; there remained only the task of replacement, renewals, and modernization; and provision for a modest secular growth. These *real* factors and their impact upon the investment cycle and level of employment are almost entirely overlooked in the overly simplified monetary approach.

The notion that putting out currency issues in exchange for bonds can cope with mass unemployment when investment outlets have temporarily been largely exhausted flies in the face not only of analysis but of experience as well. True, if the bonds are purchased from the unemployed, they can be counted upon to spend the money. But such spending would be a drop in the bucket. Employed workers, fearful of possible future unemployment, are likely to hang on to their savings. If the bonds are purchased from the rich and well-to-do, larger cash holdings will not induce them to spend more on consumers' goods, and real investment outlets are, under the circumstances, limited in scope. Business firms will not expand plant and equipment merely because they may have been induced, under a favorable bond market, to exchange securities for cash. Flooding the market with cash, under these circumstances, will have little effect on either investment or consumption. That the decade of the thirties demonstrated on a large scale. If it is replied that cheap money induced a housing boom in England, a large part of the answer is that private residential construction had run at a low ebb all through the twenties in England, and no saturation had been reached, such as we experienced by 1928 in the United States as revealed by the rising vacancy rate.

Mints at any rate (unlike many of the other 100 per cent reserve adherents) clearly recognizes that the mere increase in liquidity may not turn the tide, and so as a further positive policy he suggests tax reduction. As I have already explained in Chap. XI, with so large a federal budget as we shall have in the future, mere tax reduction, if carried far enough, could probably stimulate consumption (and to some extent investment) sufficiently to produce full employment. But it does not follow that full reliance on tax reduction as a fiscal device (nonfiscal measures would of course also be applied) is a wiser policy than one that

combines increases in public outlays with tax reduction. The use of both methods—variation in outlays and variation in taxes—has the great advantage that under this program the deficit would be materially smaller.

Complete reliance upon tax reduction is a pretty drastic procedure. The stimulating effect of a given volume of tax reduction is not equal to the stimulating effect of an equivalent increase in outlays. A billion-dollar tax reduction will not cause private individuals and business units to spend an additional billion dollars. But a billion-dollar increase in public outlays will all be spent on employment.

Even a moderate tax variation (such as I propose) is politically difficult. For this reason, some fiscal theorists, while favorable to cyclical variation in tax rates, prefer on grounds of practical policy a stable but graduated tax *structure* under which tax *revenues* would rise and fall with national income, but rates and exemptions would remain unchanged. Even this would provide some measure of cyclical compensation. But it is not enough.

We do need to vary the tax rate. And we also need to vary public outlays. The problem of maintaining stability and full employment is a very difficult one. We do well not to underestimate it. Overreliance on one single policy is likely to discredit it. A sudden pouring out of vast issues of currency, through tax reduction drastic enough to maintain full employment, is not a good way to promote stability. And it is quite unnecessary, since other means are available.

It is sometimes said that stable public expenditures are per se desirable. It is true that much of the budget should not be allowed to vary cyclically, but should only be adjusted secularly in accordance with the needs of growth and rising standards. This is true of most services like education, health, and standard community services. But some service outlays can be varied countercyclically. And with respect to public construction, there is a definite advantage in varying the rate, since this is one important means of stabilizing the whole construction industry. Private construction should indeed be stabilized as much as possible, but it would be utopian to hope that it will not continue to fluctuate widely. Public construction, or rather some considerable part of it, can be used to offset these fluctuations. This will tend to stabilize the

construction industry as a whole. Public construction is usually done under private contract. Thus as privately financed projects fall off, private-construction contractors would turn to publicly financed projects and the industry as a whole would become fairly stabilized. With publicly financed construction averaging around 7 or 8 billion dollars and private projects around 10 billion dollars, a high degree of stability is within the reach of practical policy.

I have urged for some years variation of the basic or standard income-tax rate. But I see no merit in varying the level of income-tax exemptions in preference to varying the basic rate. Exemptions ought to be fixed at a level that protects the low-income groups from being pushed by taxation below a nationally established minimum. The basic rate and the surtax rates should be determined broadly in terms of the criterion of economically and socially desirable income distribution. The basic rate may be varied cyclically as a compensatory device. But there is no good reason why the basic *minimum* below which no income taxes are collected should be altered according to the cycle. The principles upon which this minimum rests have nothing to do with the cycle. Moreover, on adminstrative grounds cyclical variation in exemption would complicate the problem of tax deduction from pay rolls. A change in the basic rate, in contrast, is a very simple statistical matter.

Nor do I find good reasons to suppose that the issue of currency by the Treasury is a better method of financing outlays not covered by taxes than those currently in use. If circumstances point to the desirability, when there is unemployment, of increases in the money supply, that is equally as feasible under current practices as under the novel procedure of the 100 per cent reserve school. All that the Treasury needs to do is to borrow from the banking system. Current procedure includes all the tools needed for a rational monetary and fiscal program. It permits whatever combination of (1) taxation, (2) new money, and (3) borrowing from the public is deemed desirable. These, indeed, are also the methods of Simons and Mints. The only difference is that their new money is created by interest-free currency issues, while under current practices in all modern countries it is created by borrowing from the banking system (commercial banks and central banks,

directly or indirectly) with usually a very low rate of interest. From the standpoint of ensuring an adequate money supply there is no difference. The difference relates only to interest vs. interest-free financing.

I see no merit in the sharp dichotomy proposed by Simons between "currency" and "consols." The first is interest free and the second would carry a long-term interest rate. The fact is that the community wants a far more diversified assortment of liquid assets. Individuals and business want to hold assets ranging all the way from cash, through 3-month Treasury bills, 9- to 12-month certificates, 3- to 5-year notes, to intermediate, long-term bonds, and savings bonds. What advantage there could be in forcing upon an unwilling public a "take it or leave it" choice between "currency" and "consols" has certainly not thus far been disclosed by anyone.

I have already discussed the matter of interest payments to banks as a means of financing the cost of supplying the country with an adequate medium of exchange in lieu of service charges. The proposal to provide desirable increases in the money supply by issuing interest-free currency instead of selling interest-bearing securities to the banking system (commercial banks and Federal Reserve Banks [7]) loses much of its glamour once it is seen that the costs of banking services have to be carried one way or another. The only question is which way is best. I do not see any evidence that the American public would favor a tenfold increase or thereabouts in service charges to the present interest subsidy. If indeed the interest payments are excessive, we need no such revolutionary changes in our monetary system as have been proposed to remedy this situation.

Nor are the alleged advantages of further "monetizing" the public debt obvious. A large part of the debt is already monetized —namely, that part held by the banking system. For reasons given above there are no real gains to be made from changing the *form*

[7] Insofar as the debt is held by the Federal Reserve Banks, the debt is in effect interest free, since all the profits (above the minimum dividend rate) of the Reserve Banks ultimately belong to the government. The Federal Reserve Banks currently hold around 24 billion dollars of government obligations. Ways and means of shifting some part of the holdings now held by commercial banks to the Reserve Banks while at the same time retaining control over excess reserves is a matter that deserves further study.

of this monetization in the particular manner prescribed by the Simons-Mints formula. And as for the rest of the debt, its arbitrary monetization would create a money supply so great as to force a decline in the rate of interest below a level that might be regarded as desirable, or at any rate the decline would be at too rapid a pace. Moreover, it is by no means clear why the public should be denied the privilege of holding the desired volume of earning liquid assets on top of the desired volume of cash assets. There is ample evidence in experience to show that the American people wish to hold a volume of earning assets far above the value of privately issued earning assets at the current internal value of money. This they could not do without a large interest-paying public debt.

Alternative Methods of Financing.

Apart from the monetization of existing debt is the problem of current financing. How much should be financed by borrowing from the public and how much from an increase in the money supply (however effected) depends, I think, fundamentally upon one's view with respect to the desirable level of the rate of interest. The rate of interest will be determined in large degree by the relative use made of (1) the multiplication of money or (2) borrowing from the public. Having decided upon an appropriate level of interest rates, however, various combinations of (1) public spending, (2) tax revenues, (3) borrowing from the public, and (4) multiplication of money can be applied to produce full employment at substantially stable prices. A stable price level alone is no adequate criterion on the basis of which it can be decided how much of a deficit shall be financed from borrowing from the public and how much by multiplication of the money supply.

Full employment at a substantially stable price level could, of course, be achieved quite well without financing by securities sold to the public. It could be achieved by varying (1) expenditures, (2) taxes, and (3) the multiplication of money. This alone, however, in no way answers the question whether (1) borrowing from the public, (2) no borrowing, or (3) retirement of debt held by the public is desirable policy. Many other matters must be taken into account.

In my view, a widespread ownership of property claims (assets)

is a positive social benefit. Property claims may be broadly classified into the following categories:

1. Equities.
2. Private debt (other than demand deposits).
3. Public debt.
4. Money (demand deposits and currency).

In all advanced countries the amount of assets that the public desires to hold far exceeds the property claims represented by equities and private debt. Equities and private debt, while mostly representing specific things, like houses, factories, etc. (tangible wealth), derive their value from expected future income. Capitalization of good will, however, represents no tangible asset, but is based exclusively on expectations of income. So, also, with respect to money and public debt. Not being based on any *specific* goods, they represent claims of more general applicability. As property claims they depend exclusively upon confidence that the economy will continue to function effectively to produce a large flow of goods and service. What is important is the expectation of a high and rising real national income. The value of these assets is based upon expectations with respect to the value of money and confidence in the credit of the government. These in turn depend upon the capacity of the economy to turn out goods and services.

The total volume of highly liquid assets (money and public debt) may rise to greater or smaller magnitudes without producing inflation,[8] varying with (1) the intensity of the desire of the public to hold assets (to save or to hoard) and (2) the burden of taxes. The stronger the desire to hold assets, the greater the volume of highly liquid assets (money and public debt) that can be issued without producing inflation. Similarly, very large assets in

[8] The amount of money that the public has wished to hold has increased historically far more rapidly than income. Thus in 1870 the money supply in the United States was only 20 per cent of the national income, while in 1929 it was about 65 per cent. (See J. Philip Wernette, *Financing Full Employment,* Harvard University Press, Cambridge, p. 46.) "Over a period of 140 years the United States absorbed large and increasing amounts of money without price inflation because the population grew, and the average person's wealth and income rose, causing him to want to hold more money." (*Op. cit.,* p. 47.)

Unfortunately Dr. Wernette does not present the data with respect to an equally significant tendency, namely, the desire of the public to hold an increasing volume of interest-earning assets.

these forms may be held without producing inflation if current income is heavily taxed, since under this situation the tendency to spend (stimulated by the large assets held) is restrained by the deterrent effect of high taxes on spending.

On the one side, a society enjoys obvious advantages if it holds large claims; on the other side, there is a limit to which claims can be held without creating inflation—this limit depending in part upon the tax rate. Since taxes have in various ways deleterious effects on the economy, it is reasonable to suppose that there is an optimum volume of property claims for any given society. Thus, while some level of public debt may be desirable, there are nevertheless limits beyond which the disadvantages become serious. The same holds true for the money supply. There are limits beyond which liquid claims (money and bonds) will be inflationary. It is a question of balancing advantages and disadvantages. And with respect to debt, public or private, I do not understand the Mints-Simons assumption (so far as I can see without argument) that there is some peculiar virtue in limiting the property claims of a society wholly to equities and money. With respect to both private debt and public debt there are both advantages and disadvantages which need to be continually appraised with a view to achieving an appropriate balance.

At this point it may be useful to contrast the Mints-Simons program with that urged by Lerner. Lerner, if I understand him correctly, would raise the propensity to consume to a level adequate to ensure full employment by thoroughly saturating the desire on the part of the public to save. He would do so by tax reduction, by an increase in public spending, or both. He would finance the deficit by sale of bonds to the public or by expanding the money supply.[9] He is not concerned how large the interest-bearing debt becomes, since even the interest on the debt may be financed, in his view, by further borrowing or by increasing the money supply. Eventually, however, an equilibrium would be reached, and the public debt or the money supply would cease to rise. This equilibrium would be reached because the assets held

[9] Lerner calls this "printing money," which I regard as obsolete language, since the modern method of increasing the money supply is through an increase in bank credit—either commercial bank credit or central bank credit, or both. See *Social Research,* February, 1943.

by the public would eventually become so vast that they would tend to spend all of the current income in excess of that invested in private-capital formation. At this point full employment could be maintained without public loan expenditures. At this point all public expenditures would indeed have to be financed by taxes in order to prevent property claims from rising to a point at which the inducement to spend would become inflationary.

According to Lerner, the propensity to consume might be raised either by ever-increasing bond holdings or by the multiplication of the money supply. The propensity to consume could be raised by saturating the desire to hold assets, whether money or securities. The two methods, however, would have a very different effect upon the rate of interest. Alternatively, the desire to hold money and the desire to hold securities might both be satisfied simultaneously in proportions that would tend to hold the rate of interest stable or moving in any desired trend.

The degree to which the desire to hold assets can be satisfied without creating inflation depends on the level of taxes that is deemed appropriate after balancing all the advantages of holding property claims against the disadvantages of paying taxes. With Lerner [assuming that the desirable level of public expenditures has been determined and that account has been taken of (1) the best use of resources and (2) the total level of expenditures, public and private, necessary to produce full employment] the tax rate should be as low as possible consistent with the prevention of inflation and an appropriate distribution of wealth and income.

For myself, I think a good deal is to be said, on practical grounds, for the proposal to cover (over the cycle) operating government expenses by means of taxes, while financing developmental and improvement projects from borrowing.[10] I would by no means be dogmatically tied, however, to this rule. [The ultimate criteria that ought in the final analysis to control are (1) full employment, (2) public outlays in accordance with social priorities, (3) prevention of both inflation and deflation, and (4) the most favorable distribution of income socially and economically.] Even the rough rule referred to above would involve deficit financing of operating or current expenses in depression years. With respect to borrowing for developmental and improvement projects the

[10] *Cf.* Sir William Beveridge, *Full Employment in a Free Society.*

financing should, I think, involve borrowing from banks to the degree necessary to achieve liquidity adequate to ensure a low rate of interest. The rest should be borrowed from the public. If the total desirable volume of public expenditures considered from the secular standpoint is not adequate to produce full employment under these methods of financing, taxes ought to be reduced. Thus from the secular standpoint I should favor a combination of all three methods of financing. And from the cyclical standpoint I should favor varying both expenditures and tax revenue, financing the deficit partly by borrowing from banks and partly by borrowing from the public, the proportion between the two being determined by the requirements of liquidity and interest-rate policy.

This program would satisfy reasonably well, I should think, a number of relevant criteria for fiscal policy:

1. The preservation of the value of money or a substantial stability in the cost-of-living index.
2. The preservation of government credit through the continued demonstration of adequate fiscal capacity and taxing power.
3. A reasonably satisfactory distribution of wealth controlled in part by the relative use made of taxation and of borrowing and partly by the progressivity of the tax structure.
4. Full employment of resources, and rising national income as rapidly as productivity permits.

Graham's Storage Plan.

Another variant of the interest-free proposal is that advanced by Professor Frank D. Graham in his Storage Plan. Graham, unlike Simons and Mints, believes that public expenditures should be increased when conditions of deflation and depression are present. However the increased expenditures should not be made on public-improvement or development projects, but on *standard* storable *goods* purchased from private producers. On the other side, with respect to variation in taxation, he thinks that this cannot be used to prevent inflation because taxes are never popular.

On the appearance of sagging markets, Graham would have the government undertake to purchase any excess of *standard storable goods* (above a normal inventory) at a price sufficient to cover

out-of-pocket expenses. Payment would be made not out of tax funds or from borrowing, but by deposit credits issued by a subsidiary of the Federal Reserve System—the Federal Reserve Corporation (which his plan sets up). The enterpriser would transfer the "deposit credit" to his own commercial bank in exchange for a deposit in that bank. Cash holdings of producers would thus be increased, and so total expenditures "will be automatically kept at the level necessary to take off the market all the goods that can be produced at full employment." [11] Money incomes would be paid out to workers and other factors by reason of the continued production of the *standard storable goods* which the FRC would purchase.

The financing of the stocks stored under seal would be interest free. Title to the goods, subject to the FRC's lien, would remain with the enterpriser so long as he stayed in business. The FRC could not sell the goods and so there would be no threat of goods overhanging a weak market.

As this process went on for a while, it is expected that demand would sooner or later outrun the supply of goods put on the market, and so prices would tend to rise. At this point enterprisers would take the goods out of storage and the excess of supply would be met by goods drawn from stock.

While a commodity credit corporation could, within limits and as a part of a more general program, play a role in stabilizing the prices of storable raw materials,[12] I do not believe that Graham's scheme, as a device to cure the business cycle, maintain full employment, and stabilize the general level of prices, is practical. The goods that are confronted with a serious decline in demand, when depression comes, are primarily capital goods. This means locomotives, railroad equipment, machinery of all kinds, construction materials of all kinds. To keep on producing all this goods, as is suggested under the Graham scheme, at the rate at which they are produced in boom years, would quickly develop into a vast stock of utterly unusable goods. The depression of 1929, for example, came just because all of these things had been produced to the point of high saturation—the capital requirements de-

[11] *International Post War Problems,* October, 1945, p. 475.

[12] See Alvin H. Hansen, *America's Role in the World Economy,* Chap. XII.

manded by the level of technique and by growth had been largely filled. To keep piling up these things would be sheer folly. If, then, the FRC refused to store capital goods and instead purchased consumers' goods (for storage) so that nearly all the productive resources were now diverted to making consumers' goods, the question arises, Who will buy all these consumers' goods since at full employment individuals and business firms wish to save a considerable fraction of their income? Rather than continue to finance the piling up of consumers' goods, it would make more sense to increase public outlays on useful and productive public improvement and development projects, low-cost public housing, and other outlays that promote high standards of consumption and investment, while at the same time reducing tax rates to stimulate both consumption and investment.

Production for stock is within limits a useful depression device for some commodities, and it is especially being explored, as we have seen, in Sweden. At the same time, the Swedish Postwar Committee warned against enterprisers attempting to install equipment in depression years in preparation for enlarged sales in later years because of the danger of rapid obsolescence. A depression consists in large part of a decline in the demand for fixed capital, and for these things the storage plan is not practicable. There are grave risks in large storage even of standard raw materials, much more of specialized manufactured consumers' products and of producers' capital goods in general.

With respect to financing, I have already analyzed above the relative merits of interest-free schemes and current procedures. This part, therefore, requires no further discussion.

Chapter XIX

Tax on Idle Money

A VARIETY of proposals have been made designed to maintain adequate aggregate demand by taxing idle funds. These proposals, while varying in detail, have common characteristics.[1] It is argued that if all the income received in the current process of production is promptly expended for goods and services or for taxes (promptly spent by government) the aggregate demand in the ensuing period would be adequate to employ the labor force. It is then proposed to ensure this situation by imposing a tax on idle cash (currency or deposit balances) in order to keep up the flow of spending.

Money as a Store of Wealth.

Money should not, it is said, be used as a store of wealth but only as a medium of exchange. Idle funds should either be used promptly by the owner himself, or advanced or given away to someone else who will use them, or else taxed away by the government to ensure that they will be put into circulation.

The intent is, however, that the owners shall be induced by the tax on idle funds to put them into circulation. In this way private spending could be made adequate. It is moreover contended that, while private business and individuals are entitled to spend their own income on consumption or investment, they are not entitled to hoard (withhold income received, from being respent) because this action brings depression, deflation, and disaster upon the entire community. Hoarding is antisocial.

Velocity of Money.

Adherents to this plan recognize a defect in the "quantity of money" approach. Varying the quantity of money will not control

[1] See, for example, the various plans that are presented and discussed in Monograph No 25, Temporary National Economic Committee; also George R. Walker, "Silvio Gesell and Private Enterprise," *Harper's,* July, 1946.

the total volume of spendings on goods and services, since the velocity of money turnover may change. If, however, one combines control of the quantity of money with control of velocity, could not the flow of total expenditures be regulated so as to produce stability and full employment?

The "tax on hoards" is an effort to control the velocity of money. But the method is not adequate to accomplish this end. The plan seeks to prevent hoarding by imposing a tax on the holdings of currency or demand deposits in excess of a given amount—say $500 of currency and $2,500 of demand deposits, or some other appropriate figure. Time deposits must somehow be controlled to ensure that they represent long-term real investments, and not just a device for hoarding idle funds.

For business concerns, the volume of cash holdings that would be tax free might be adjusted according to size. Some proponents have merely suggested a tax on corporate retained earnings not invested in fixed capital. But this is something different from a tax on hoarding.

Control of Total Spending.

A superficial criticism may first be noted. A scheme to ensure that income earned today would all be spent tomorrow, it might be objected, will not be adequate to provide full employment in a society with (1) a *growing* labor force, and (2) increasing per-worker productivity. This is true, but an easy answer is ready at hand. More *money* may be created by the monetary and fiscal authorities. If now in addition, by means of the tax on hoarding, the velocity of turnover of money could be maintained at a constant rate, then the total flow of spending could be increased sufficiently to take off the market all this goods produced by a growing and ever more productive labor force.

In point of fact, however, the matter is not so easily settled. Even though the volume of money were controlled, the tax on idle funds could not control the flow of total money spendings so as to ensure precisely the correct volume of aggregate demand. The tax on hoards cannot control the *rate* of money turnover. Whatever tax-free hoards of cash are allowed, *this* volume of money could have a high or low rate of turnover regardless of the tax on *excess* cash holdings. Evidently what is needed is to

control the rate of *total* expenditures of the community as a whole.

The appropriate cash balance (not subject to tax) for each individual varies according to income, size and composition of family, nearness to consumers' markets, degree of urbanization, the rate of interest, saving and spending habits—in fact, innumerable considerations. And even if the correct untaxed balance could be established, there would remain the question of how to prevent undesirable fluctuations in its rate of turnover.

Adherents of the plan to tax idle funds are typically concerned with the problem of deflation. The aim is to prevent a *fall* in the rate of spending. But a tax designed to prevent the accumulation of tax hoards will not of itself alone prevent a decline in total spending. This is evident from the fact that typically in depressions the volume of cash holdings (currency and demand deposits) falls drastically. Obviously individuals and business units do not usually accumulate ever-growing cash hoards in depression periods. That is not the nature of a depression. At the bottom of a depression there are often no vast idle hoards. Currency in circulation plus demand deposits fell from 27 billion dollars in 1929 to 20 billion dollars in 1932. So also in earlier depressions. Income currently received may be used to pay off debts at the banks. Demand deposits thus decline. The failure to spend on goods and services does not, in this case, result in an accumulation of hoards of cash. On the contrary, it may lead to debt cancellation and to a reduction in total cash holdings (currency plus demand deposits). Merely to tax cash hoards will not ensure that cash holdings shall not decline. A tax on hoards may even accelerate debt cancellation and credit contraction.

If, however, government action is taken to maintain or even increase the supply of money (currency and demand deposits), then the question arises whether the activation of cash holdings (deliberately created by the monetary and fiscal authorities) might be achieved by means of a tax on idle balances. In the recovery from 1934 to 1937, the money supply increased rapidly, partly as a result of the gold inflow and partly as a result of the federal government's borrowing from banks. This vast increase in money, however, did not circulate rapidly. Velocity was low. It was "idle

money." This situation doubtless greatly stimulated a widespread interest in schemes to "tax hoarding." [2]

Let us assume that action had been taken early in 1929 to prevent a fall in the money supply. This could have been accomplished quite easily by creating a large government deficit (tax reduction and an increase in government outlays), financed by borrowing from the banks. Let us suppose that this action was accompanied by a "tax on hoards," so fixed that the tax-free cash holdings were considerably below the volume of currency and demand deposits.

Forced Investment.

If effectively administered, such a tax would have had the effect of activating demand deposits. These "excess" deposits were largely held by business concerns and by well-to-do individuals. Business concerns might have been compelled by the proposed tax either to invest in fixed capital—plant and machinery—or else to distribute their excess funds in dividends. If investment was made on new plant and machinery, this process in effect would transfer the excess cash holdings to newly employed workers who would probably maintain a good rate of turnover of the money supply.

But in view of the temporary saturation of investment, a forced investment in fixed capital would be wasteful. By 1929 the productive facilities for new and old industries alike had been built up to a high level of capacity. New machinery, representing advances in technique, had been installed. The railroad plant had been expanded and improved. Residential housing had reached a condition of temporary oversupply [3] showing itself in a growing vacancy rate. Office buildings and hotels had been overbuilt all over the country Eventually, growth and advances in techniques would again open investment outlets. But to force investment under the conditions typically prevailing in a depression by means

[2] It should be noted that the "idle money" was not the result of voluntary accumulations from disposable income. It was the result partly of the gold inflows due to the chaotic international situation and partly of government financing policy.

[3] This of course does not mean that the American people were properly housed; it means that the *demand* for houses, unaided by a positive government program, was saturated.

of a tax on hoards would not be a wise use of resources. What is needed is to raise consumption and to make good the serious deficiencies in the public sector of the economy—slums and blighted areas in cities, flood control, reforestation, resource development, public power projects, etc.

Business concerns might, however, have distributed their cash balances in dividends. About this solution, however, several comments need to be made. The matter is not so simple. Many concerns, for example in the period 1930-1938, were making no profits. Yet they were accumulating cash balances in the banks because they concluded (often wisely) that it was not good policy to expend their depreciation allowances on new plant and equipment. They already had ample and up-to-date productive facilities. Thus cash balances accumulated even though no profits were made. Without profits, dividends could not be distributed. The accumulation of large cash balances is not necessarily caused by failure to distribute profits.

Forced Spending.

Nevertheless, some part of the cash holdings was already in the hands of well-to-do and wealthy individuals, and part of the cash holdings of some corporations might have been distributed to stockholders. A tax on excess hoards might force these individuals to buy securities or to increase their consumer spending. This latter would mean a transfer of funds to workers and would stimulate total community spending. But the initial forced increase in consumer spending by the rich above the customary levels hardly recommends itself as a wise use of the nation's productive resources.

Reduction vs. Activation of Money.

The purchase and sale of existing securities between individuals and firms is obviously no solution, since such a process would not increase employment. Demand deposits might, however, be used to buy securities from banks, but this would reduce the total volume of money. If this were allowed to happen, idle money would indeed disappear, but so also would all prospect of an adequate flow of total expenditures.

The "tax on idle money" is designed, as we have noted, to *ac-*

tivate cash holdings, not to *reduce* them. Merely to place a tax on cash holdings above a certain given minimum may only induce people to *reduce* their cash holdings, not to *activate* them. After the holdings have been reduced to the level below which no penalty tax applies, this volume of cash balance may remain largely inactive, the rate of turnover being adjusted to the level of expenditures that it is desired to make.[4]

To make the "tax on idle money" effective, the money supply must be kept up and it must be turned over at a normal rate. Accordingly, bank assets must not be allowed to decline. In other words, banks must not en masse unload securities to the public.

If the banks are left out of the picture, the only effect that will follow from the frantic effort to dispose of excess cash holdings in exchange for securities is that wealthy individuals and corporations will be bidding securities up until the yield on bonds is forced down to a very low level. The "tax on idle money" will indeed drive the rate of interest down since nobody will want to sell securities and everyone will try to buy them. The low rate of interest is then expected to stimulate consumer spending or investment.

These schemes seek especially to regulate the rate of private spending of well-to-do individuals and business concerns—the only segment of the country with any appreciable volume of so-called "idle funds." If they are to be compelled to maintain a certain rate of expenditure, this means that they must purchase either new producers' goods or consumers' goods. But producers' goods may already be in surplus—this is indeed the essential cause of depressions—and therefore a forced investment in more and more fixed capital of all kinds is not a sensible or economic policy. A forced volume of purchases of consumers' goods by wealthy individuals above their accustomed standards is also a wasteful use of resources.

[4] "Dated money" is another device to ensure a high rate of turnover. Under this scheme, after a certain date money will lose its legal-tender quality or else at stated intervals be assigned a progressively vanishing value. This scheme would indeed induce people to get rid of such money in order to avoid the depreciation in value. But what is there to assure that the speed of circulation is precisely right to avoid both inflation and deflation? And can anyone really seriously believe that a depreciating currency is a good basis for economic stability?

The Savings-investment Problem.

Clearly the "tax on idle funds" does not get at the root difficulty —the savings-investment problem. What is needed is either to raise the propensity to consume by a better distribution of wealth and income (wage-price policy, tax policy, etc.); or else to fill the gap between private outlays (consumption plus investment) and the desired full-employment income by useful and productive public outlays; or some combination of both these policies. The tax on idle funds, if effective, would maintain employment by forcing wasteful expenditures on excess plant and equipment or on extravagant consumption by the rich.[5] It would mean a misuse of resources, a violation of the principle of social priorities. It would not achieve a balanced flow of useful expenditures, public and private.

Value of Large Liquid Assets.

The view that the holding of large liquid assets in the form of cash (currency or bank balances) is peculiarly undesirable will not stand up under examination. The holdings of large liquid assets by business concerns, as is now the case during the reconversion period, may promote desirable outlays on plant and equipment.[6]

[5] Gifts for charitable and welfare projects would be another outlet, but a vigorous and self-reliant democracy will not wish public education, health, and social-welfare measures to be dependent mainly upon private gifts.

[6] *The Key to Full Employment without Regimentation* by Berkovits and Atkins (Longmans, Green and Company, New York) presents another device to activate idle savings as follows:

1. Banks shall invest in productive facilities as much of the people's savings deposited with them as possible.
2. Banks shall remit to the central bank all excess savings deposited with them which cannot be productively invested.
3. The government shall borrow these idle savings from the central bank without interest.

The net effect of this scheme is that banks would hold, as an asset against "excess" savings deposits, a reserve at the central bank in lieu of the government bonds now held. Losing the interest, the banks would have to be subsidized or else charge heavy service charges. The government would get the use of the funds interest free.

Apart from the procedural difficulties, which are rather obvious, the issues raised by this proposal have already been discussed in this and the preceding chapters

Moreover, there is under varying conditions an appropriate balance between (1) non-interest-bearing assets (cash), and (2) earning assets. What that balance may be depends, among other things, on what one regards as a desirable rate of interest. If in a free market one wishes a low rate of interest, then a high ratio of cash holdings to earning assets is necessary. It is true that, under the compulsion of a tax on idle funds implemented in conjunction with a control of the money supply, the rate of interest can be driven down (assuming that the plan can be effectively administered) to any desired level. But this objective can easily be accomplished by other methods. All that is necessary is to ensure adequate liquidity. The fiscal and monetary authorities can create any desired volume of money and this will assure a low rate of interest.

Under a system of free choice with respect to the character of assets held, a low rate of interest necessarily will induce a desire to hold a considerable volume of cash. If the rate of interest is high, one can afford to risk all one's holdings in the form of earning assets. The high yield serves as a kind of insurance premium to protect against loss of principal. But if the yield is low, it becomes necessary to hold a part of one's assets in a form that involves no risk whatever of loss of principal. Money is such an asset. The disadvantage of not earning an income from that part of one's assets that is held in the form of money (currency or demand deposits) is balanced by the certainty that the principal is safe. The loss of income represents a kind of insurance premium paid (so to speak) for complete security with respect to the principal. If a certain part of one's assets is secured in this manner, one can risk the rest in the form of earning assets, which do yield an income, but which involve the risk of loss of principal. The lower the rate of interest, the more necessary it is, in order to safeguard the principal, to hold a large part of one's assets in cash. Thus a low rate of interest in a free investment market induces large holdings of cash. Conversely, a condition of high liquidity—the creation of a large money supply by central bank and Treasury action—will induce the purchase of securities in order to reestablish the desired ratio of cash to earning assets. Thus an increase in the money supply will tend to lower the rate of interest. Accordingly, the rate of interest is one of the deter-

minants of the ratio of cash assets to earning assets desired by the community as a whole. And if that ratio is disturbed by a further increase in the money supply, the rate of interest will be pushed lower. A functional relationship therefore exists between the rate of interest and the volume of money that the public wishes to hold. The public will hold varying quantities of money according to variations in the rate of interest.

The Problem of Retained Earnings.

While, as I see it, a tax on idle money is not a suitable device to cure unemployment, some useful adaptation of the general idea underlying the proposal can, I believe, be made. The suggestion which I have often proposed runs, however, not in terms of *forcing* the use of liquid funds, but rather of providing an incentive to invest. The proposal is to relieve corporations in a measure from taxation on that part of retained earnings which is invested in fixed plant and equipment. To make the inducement to invest effective, a fairly high tax should be imposed on that part of retained earnings which is not invested in fixed capital.

Such a tax would tend to promote investment and reduce the accumulation of unused balances. It is not, however, a tax on idle funds as such. Idle funds could still be built up by failure to invest current depreciation allowances. To meet this situation it has been proposed that the income tax should apply to gross corporate income (prior to depreciation and taxes) minus dividend distribution and investment in fixed capital. Nevertheless, despite any of these taxes, large liquid funds including cash holdings might be held by the corporation. They might already have formed part of the assets at the time the proposed tax on uninvested depreciation allowances and retained earnings was instituted. They might be acquired against the sale of existing assets such as excess inventories, securities, receivables, etc. At any rate, under this proposal, it would not be possible to add to the holdings of liquid assets from current income without paying the regular tax rate. The effect is to promote the distribution of earnings to stockholders and to stimulate investment in fixed plant and equipment without prohibiting desirable accumulations of liquid assets.

PART SIX

MANAGING A FULL-EMPLOYMENT ECONOMY

Chapter XX

Inflation Risks under Full Employment

UNDER a free-market economy we are never secure and safe. We are always in danger. If the income, employment, and production happen currently to be moving smoothly onward, there is no assurance that this will continue for long. On the contrary, impulses are continually being injected which tend to throw the economy off balance. Once this happens, a cumulative process begins, which if unchecked may throw the economy far out of equilibrium. A free-market economy is risky, uncertain, and inherently unstable.

Old and New Risks.

Business-cycle literature, especially during the last 50 years, has analyzed the nature and causes of economic fluctuations. Under the play of automatic forces, entrepreneurs, workers, and owners of property faced grave risks. There were violent price movements. Profits and losses were perpetually wrestling to push each other off the business stage. Unemployment for workers, bankruptcy for farmers and businessmen, were ever just around the corner. The birth and death rates for business units revealed how risky a thing free enterprise was, operating under the automatic forces of competition in a market economy.

But if the government undertakes the responsibility for the maintenance of full employment, the old risks will not easily be overcome, and new ones will emerge.

The free-enterprise economy in the period 1840-1940 did not automatically generate the appropriate stream of expenditures. The flow at times was too large, and the result was an unhealthy boom and sometimes inflation. At other times the expenditure

flow was far too small, and the result was unemployment and deflation. It was an endless seesaw, and with it came and went social disturbances and political upheavals. That these usually subsided without producing revolutionary changes in the social structure can in part be credited to the large rural and agriculture base upon which an ever-growing urbanized society was developing. A significant point in economic evolution was reached when the urbanized, industrialized sector outweighed the rural sector. It is this that has made economic instability no longer tolerable. The government can no longer stand by while the economy plunges from "boom to bust."

Thus it has at long last become necessary for the government to take positive action designed to provide a stable and adequate flow of total expenditures sufficient to assure full employment. But is this possible? Can the economic car be kept in the middle of the road? We have suffered in the past from deflation, unemployment, bankruptcy. Will not full-employment policies and programs, all over that part of the world which operates under a free market, blow off the lid? Shall we be able to escape the consequences of inflation?

Full-employment programs are loaded with inflationary dangers. To deny that would be folly. We must learn what they are; and we must gird ourselves to master them.

The government can exert a powerful influence on total expenditures (1) by altering public outlays or (2) by inducing changes in private outlays by varying tax rates and other measures. The government can thus directly and indirectly assure a level of total expenditures adequate to provide full employment. But the added expenditures injected or induced may be dissipated by inflationary price increases instead of absorbing the unemployed. Control of aggregate demand will not necessarily ensure full employment.

A Seller's Market.

Expansionist measures create a seller's market. It is not only a seller's market for consumers' goods and services. It is also a seller's market for all products, final or intermediate. It is also a sell-

er's market for the factors of production. The labor market, the real-estate market, the securities market are all buoyant.

Expansionist measures raise the spirit of optimism. Consumers tend to spend freely from current income and to buy on credit. Continued application of expansionist measures is likely to produce growing accumulations of liquid assets. These provide an underlying basis for inflationary tendencies.

Bottlenecks.

Expansionist measures in a growing society with ever-changing techniques and products will encounter distortions and bottlenecks. In some areas supply will be highly inelastic. Elsewhere there will be unemployment, idle resources, and unused facilities. Ever-growing aggregate demand will spill over into markets for specialized goods and services which the established supply pattern cannot satisfy. There will thus be shortages and surpluses side by side. The production pattern will not fit the demand pattern. The distortions and bottlenecks will be geographical, industrial, and occupational in character. Labor and capital must continually transform themselves through technical education of youths and retraining of adults, and through obsolescence and replacement. Moreover, relocation and migration are necessary in order to achieve an optimum use of natural resources. Expansion facilitates this process, but the adjustments are not automatic. Distortions and bottlenecks appear.

Spurts of Investment.

The new frontiers of expansion (new industries, new processes, and new products) require a bunching of capital formation in the interval while the spearheads of progress barge forward. Once the new "terrain" has been occupied, some of the productive factors can be dispersed to other areas. The normal processes of maintenance and operation are very different from the processes of initial investment and development. The production pattern is constantly shifting. Under conditions of high aggregate demand, these shifts in the production pattern are likely to set off inflationary explosions here and there, while at the same time the shifting pattern in other areas creates pockets of unemployment.

Competition Diminished.

In a general situation of high aggregate demand, competition between producers for the market is lessened.[1] The pressure to reduce cost, to be efficient, is weakened. Against these tendencies there are offsetting factors which will be noted later in this chapter.

Inelastic Supply.

As full employment is approached, the elasticity of supply all around will diminish. In other words, the supply curves, so long as there is unemployment, will for most industrial products run along on a fairly horizontal line. As expansionist measures push the economy up toward full employment, the curves sooner or later will tend to become vertical. How rapidly the curve changes from the horizontal to the vertical will vary greatly with different commodities and industries. If the slope rises *gradually,* inflationary pressures on costs and prices will be encountered long before full employment is reached.

It is important to distinguish between the over-all situation and that for special industries. If the supply curves for substantially all industries slope upward considerably before the point of "full employment" (as defined on page 19) is reached, the matter is pretty serious. If, however, this condition confronts only some industries—bottlenecks—then the thing is manageable.

Unit Costs.

From the standpoint of industry as a whole it was formerly believed that diminishing returns began to apply long before full employment was reached, and for this and other reasons unit costs, it was believed, would soon begin to press on profits. In support of this view it was said that before the peak of the boom was reached firms were pushed beyond the point of optimum combination of factors; in other words, the fixed factor (plant and equipment) was used too intensively. It was also urged that obsolete and inefficient plant would come into use, that the least efficient part of the labor force would be the last to be employed, and that all labor became less efficient at high-employment levels.

[1] *Cf.* Ingvar Svennilson, *Report to the Commission on Post-war Economic Planning.*

Physical Productivity.

The war experience, however, presents a challenge to this formerly widely held view. If the view stated above is correct, one should expect a progressive decline in physical productivity per worker as employment rose. This appeared not to be the case. Output per man-hour rose fairly steadily for the over-all economy from 1932 right up to 1944, as the following table discloses. The

PRODUCTIVITY, 1932-1942

(1939 = 100)

Year	Output per man-hour			Output per worker
	24 selected nonmunitions manufacturing industries	Railroad transportation	Mining	Agriculture
1932	78	74	78	93
1934	84	84	81	76
1936	90	93	87	81
1938	93	95	90	98
1940	105	105	101	103
1942	106	140	106	119
1943	104	151	109	117
1944	103	148	114	124

SOURCE: U. S. Department of Labor, Bureau of Labor Statistics, Aug 17, 1945; see *Basic Facts on Employment aud Production*, Senate Committee Print No. 4, 79th Congress, 1st Session.

manufacturing industries do indeed show a slight decline in 1943 and 1944 but this was more than offset by the gains in transportation, mining, and agriculture.

In terms of Gross National Product (at constant prices) per-worker output increased right up to 1943. This of course was partly due to increased hours, but on the other side, if the armed forces and their "product" had been excluded in the table given below, the figures for 1941-1944 would have been materially larger.

OUTPUT PER EMPLOYED PERSON (INCLUDING ARMED FORCES)

Year	Dollars (at 1944 prices)	Year	Dollars (at 1944 prices)
1932	1,902	1940	2,580
1934	2,103	1942	2,913
1936	2,366	1943	3,153
1938	2,317	1944	3,144

SOURCE: U. S. Department of Commerce.

Similarly, for manufacturing as a whole the physical product per employed worker [2] increased steadily up to 1944, as disclosed in the table below:

PHYSICAL OUTPUT IN MANUFACTURING PER WAGE AND SALARY WORKER

1938 = 100

Year	Output	Year	Output
1932	89	1940	124
1934	95	1942	149
1936	114	1943	163
1938	100	1944	167

SOURCE: Calculated from Tables B1 and C1 in *Basic Facts on Employment and Production, op. cit.*

All these data point to the tentative conclusion that for the economy as a whole, and even for manufacturing as a whole, no decline in physical output occurred until full employment was approached. Obviously, all these data are inconclusive and raise problems for further statistical investigation.

These data may be questioned in view of the reasons given above in support of the thesis that productivity declines as employment rises. The answer, I think, is that there are a number of offsetting factors not adequately taken account of in the position formerly held. First, the optimum combination of factors is apparently reached very close to full employment. Overcapacity of plant and equipment typically exists when there is considerable unemployment. In other words, plant and equipment appear by and large to be adequate for full employment. There are certainly industries for which this is not true. But in a continuing full-employ-

[2] Contrast this with the table above showing output per man-hour in manufacturing.

ment economy, this would soon be corrected. A full-employment economy would tend to cure many of the bottlenecks by inducing the building up of plant and equipment all around to the requirements of full employment.

As workers are added to increase output, a good deal of unavoidable slack is taken up throughout the organization. Many overhead factors can easily be stretched to cover a 10 or 20 per cent increase in product for the whole establishment.

Finally, improvements are continually being introduced. These increase the productivity of all workers. Even though the efficiency of the last increment of workers employed may be below the average, this fact is relatively unimportant in view of the 2 or 3 per cent gain per annum in the man-hour productivity of the whole force. Moreover, under a continuing high level of employment it would become necessary both for industry and government to train the more inefficient members of the labor force and even to rehabilitate a large part of the so-called "unemployables." No society is under any pressure to undertake such a program so long as employers can pick and choose in a surplus labor market.

For industry as a whole, then, there is apparently no convincing evidence that physical productivity must decline appreciably as full employment is approached. If this is true, there are no strong upward cost pressures which prevent the attainment of full employment unless wages are unduly raised. In special areas where pressures do arise they can in part be remedied, under a full-employment program, by enlarging plant and equipment capacity.

Breaking the Bottlenecks.

There are many things that can be done to ease the unavoidable bottleneck situations which a full-employment economy, experiencing continuing changes in techniques and products, will encounter. Bottlenecks may be broken by (1) an increase in imports, (2) *overtime* during an emergency or until increased capacity can be provided, (3) drawing on the minimum reserve of the unemployed (4 or 5 per cent) allowed for in the technical concept of "full employment," (4) drawing upon that considerable fringe of the population which can at times be induced to enter the

labor market but which normally are not in the labor force, (5) systematic stock-piling in slack seasons insofar as periodic shortages can be foreseen.

Wage Inflation.

By these and other methods it does not appear utopian to believe that full employment (as defined in this book) can be reached and substantially maintained without creating serious cost pressures due to diminishing productivity. There remains to consider the inflationary pressures springing from wage increases. If stability is to be achieved along with full employment, wages and prices cannot be left wholly to automatic forces. Wage and price policies conspicuously come to the fore.

This does not mean an authoritarian or regimented control of wages and prices. It does, however, mean comprehensive, up-to-date, and authoritative statistics on wages, prices, productivity, and costs. Moreover, adequate provision for a permanent system of federal mediation and arbitration of wage disputes is imperative.

Consideration might be given to the suggestion to establish a peacetime Office of Price Research. Such an agency would be required to report to the President and to Congress on proposed price increases, and no industry would be permitted to increase administered prices (steel, automobiles, etc.) for, say, 90 days until a full investigation had been made. Publicity, not coercion, may be relied upon for enforcement of a rational price policy—one that would promote expansion and full employment.

Recent wage demands have brought us face to face with the problem of what to do with wages and prices. We are compelled to think through the basic issues involved.

Historical Record.

A little historical perspective may be helpful. Under the play of more or less automatic forces prior to World War I, how did wage and price movements work out? Roughly, if we take the 75-year period (1840-1914), we discover these interesting facts:

1. The long-run trend of prices reveals that the price level stood in 1910-1914 at about the level of 1840-1860.

2. Money wages per week rose from an index of 100 to about 250; wages per hour rose to about 300.[3]

That money wages (and more generally money incomes of all classes) should have risen relative to prices follows inevitably as a result of ever-increasing productivity per man-hour. As output per capita increased, money incomes would necessarily have to rise in order to permit the purchase of an ever-growing volume of output at constant prices. And assuming no great change (as in fact was the case) in the distribution of income, wages per worker could be expected to rise approximately at the average rate of growth of money income.

Now, of course, wages might have remained constant, while increasing productivity expressed itself in ever-falling prices. Indeed, some economists argue that this course of events is to be preferred. This, in fact, was *not* what happened in the nineteenth century. Instead, wage and other money incomes rose approximately in proportion to increases in production. With substantially the same price level at the end of the period cited as at the beginning (we are not here considering the intermediate movements), more and more goods could be purchased as wages and other money incomes rose.

This development was, I think, a wholesome one. And now that we are compelled to adopt a conscious policy, through collective bargaining and government mediation, with respect to wages and prices, I believe we can do no better than to strive for a result broadly similar to that indicated in the illustration cited above.

Rising Wages and Stable Price Level.

Why should the gains of increasing productivity be taken out in higher wages and incomes and not in an ever-falling general price level?

To this there are several answers. In practice it is not easy under modern conditions to ensure that prices will be lowered whenever increased productivity reduces unit costs. Under modern conditions there is no automatic mechanism by which this can be accomplished smoothly and easily. There are too many monopolistic or

[3] See Alvin H. Hansen, "Factors Affecting the Trend of Real Wages," *American Economic Review*, March, 1925; *Statistical Abstract*, 1932, p. 311.

quasi-monopolistic factors present in the modern world, including the condition of "monopolistic competition." On the other hand, the machinery of collective bargaining is at hand to enforce wage increases. Moreover, wage increases represent tangible and clear evidence of progress to the wage earner. Higher wages in the pay envelope are impressive; lower prices are noticed only vaguely if at all.

There is the further point that if increased productivity were not reflected in higher money earnings, serious frictions would develop in the labor market. In order to hold weekly earnings constant, piece rates would have to be lowered every time new machinery and new production methods were introduced. To be sure, new piece rates are continually being set, but unless they are so set as to yield higher earnings, there is likely to be serious trouble. The worker will be convinced that he has been robbed of all the benefits of larger output. He is producing more and more pieces but he gets no more money. Such a wage policy would destroy all incentive to increase output. The same argument holds also for time-rate wage systems.

But this is not all. Rising money incomes (as output rises) benefit the *active* groups (entrepreneurs and workers) in the community. This stimulates progress. Debt burdens decline as income rises. The *active* elements gain while the passive elements (mortgage and bondholders) merely hold their own. Thus effort and enterprise are rewarded.

The problem of government finance is greatly facilitated by a rising money income. Even though tax rates are left constant, revenues will not only rise, but will even rise more rapidly than income if the rate structure is progressive. Thus tax burdens are eased.

International equilibrium is, moreover, facilitated by the upward adjustment of wage rates in each country in accordance with that country's gain in productivity. If increases in over-all productivity occur at different rates of change in various countries, stable wage rates throughout the world would rapidly develop a serious disequilibrium in labor *costs*. Those countries enjoying the most rapid gains in productivity would experience lower and lower unit labor costs relative to other countries. Disequilibrium in the balance of payments would therefore be created. If, how-

ever, wage rates in each country were adjusted upward in line with the increases in productivity in each separate country, the international balance would tend to be preserved.

Finally, the savings-investment problem—one of the most basic and fundamental of those confronting all advanced industrial communities—would be greatly accentuated if money incomes remained constant while prices declined. As prices fell, depreciation funds (gradually accumulated over the lifetime of the capital goods), when finally spent on new equipment, would buy far more than the amount needed for replacement. Thus, the investment outlet for *net* saving would be diminished. Moreover, the fixed-income class, whose real incomes would rise with falling prices, would tend to save more. In various ways, therefore, the savings-investment problem would be intensified.

Accordingly, there are good grounds for believing that the *long-run* movement of wages and prices broadly experienced in the nineteenth century represents the most desirable pattern. This historical development, to be sure, did not take place smoothly, but rather by fits and starts and with intermediate price fluctuations.

Real Wages after World War I.

Now for an over-all view of the current situation. Contrast it with that of 1919-1923. During World War I we witnessed a sharp rise in both wage rates and prices. Both more than doubled. In World War II, however, wage rates and prices remained comparatively stable. Following World War I there occurred a rapid rise (1919-1923) in real wages. Cost-of-living prices receded, but wages stayed at the wartime levels. In 1923 cost-of-living prices stood at 172 (1913 = 100) while the wage index was 220; wages had thus risen 28 per cent relative to living costs.

The discrepancy was still wider between wages and wholesale industrial prices—the sales prices of producers. In 1923 the industrial (nonagricultural) price index stood at 146. Wages (at 220) had therefore risen 50 per cent above industrial prices.

Over-all *real* wages thus rose sharply immediately after World War I. New methods of production, improved machinery, better organization (stimulated in part by the war) made this possible. This substantial gain in real wages provided a firm foundation

for the high buying power of the twenties. But as we moved into the late twenties, wages failed to keep pace with increasing productivity, and we experienced in consequence a disastrous profits inflation. This created an unstable situation and contributed to the stock-market boom and collapse of 1929. There was, however, no price inflation.

Current Policy.

As after World War I we have now again sought to achieve a substantial rise in real wages compared with prewar. Since we do not now wish in general to depress sharply the general price level —prices both wholesale and cost-of-living are now only moderately above the level of 1923-1929—a rise in money wage rates is desirable insofar as this is economically feasible in view of (1) gains in man-hour productivity arising from improvements in technology, (2) more efficient labor force (the men and women returning from the armed services are far superior to the youngsters and old people employed during the war), (3) lower unit cost arising from larger sales volume than we had in the prewar period.

Higher wages in place of excess-profits taxes mean in effect a transfer of funds from the government to wage earners. This is as it should be. In the postwar period the government will spend far less. but consumers must spend more, if we are to have full employment. But wages should not be permitted to rise (in relation to the prewar wage-price ratio) higher than the increase in productivity. We must avoid both a *wage inflation* and a *profit inflation.*

A Balanced Wage Structure.

This is the general over-all picture. But how does the matter stand industry by industry and firm by firm?

Wages in general should rise in accordance with *average* overall gains in productivity. But some industries can make very exceptional gains, while others cannot. Even though the management is equally efficient, the special technical conditions in different industries will cause widely diverging movements in man-hour productivity. If wages in the efficient industries absorb all the gains of increased productivity while the stagnant industries grant no

wage increases, we should very soon reach a seriously distorted wage structure.

Thus the mere fact that industry X *can* pay a 50 per cent increase in wages is no proof that it should. On the contrary, if the over-all increase in productivity is, say, 20 per cent, industry X should raise wages, perhaps a little more than the average (say 20 to 25 per cent) and pass on most of the remaining part of its exceptional gains to consumers in the form of lower prices. A highly progressive industry is indeed entitled to more than average profits. But the bulk of the gains must (or else the economic machine will soon be stalled) be passed on to workers and consumers in higher wages and lower prices.

If industry Y can make no gains in productivity, it will nevertheless be compelled to pay higher wages. Being a relatively stagnant industry, it could scarcely be expected to raise wages so soon or even so far as the progressive industries. But wages must go up, or else a violent distortion will occur in the wage structure. Since industry Y has enjoyed no gains in man-hour productivity, it must be permitted to charge higher prices.

Thus the exceptionally progressive industries will be able to *lower* prices. But the stagnant industries will need to raise prices. Industries enjoying *average* gains in productivity can raise wages without raising prices. The net effect is an all-around increase in wage rates, while the general level of prices remains stable. But while the *general level* of prices remains stable, the *structure* of prices is changing in accordance with changing technological conditions varying from industry to industry.

The Over-all View.

From what has been said, it is evident that under modern conditions we are compelled to take an over-all view of wages and prices. The facts laid on the collective-bargaining table, industry by industry, must include the over-all picture of the economy as a whole, in addition to the facts relating to the industry in question.

This is only another way of saying that the consumers of the nation as a whole (including the workers in other industries) have a vital stake in each industry bargain. The collective bargain in each industry has become a matter of national concern. The public interest must be recognized in each agreement or the general

welfare will suffer. Hence the need for comprehensive statistics bearing on the economy as a whole. These, no less than the specialized statistics of each industry, must become a part of the data controlling each piecemeal wage agreement.

Under a policy of full employment there is reason to believe that labor's sense of responsibility will increase. So long as there is serious underemployment and no rational over-all policy with respect to prices and profits, sectional wage advances will likely not only be tolerated but even welcomed by the labor movement as a whole. But this is not the case if responsibility for full employment and active policies with respect to prices and profits are assumed. Under full employment, arbitrary advances in wages, out of line with productivity and a balanced wage structure, will clearly be at the expense of consumers—in other words at the expense of labor as a whole. If the general wage level is already as high as feasible in view of over-all productivity, special wage advances in certain areas will result in an inequitable and distorted wage structure. With the over-all facts available, the labor movement as a whole may be counted upon to resist such distortion. Equally, if the facts disclose that a *general* wage increase all around can be met only by moving up prices and the cost of living proportionally, labor as a whole will gain nothing; indeed, labor will suffer a loss in the purchasing power of accumulated savings and established social-security benefits. During the war, in all the democracies, labor has demonstrated a sense of social responsibility. When society as a whole, through the government, undertakes responsibility for full employment and social welfare, labor may be expected, on past experience, to respond by living up to its social responsibilities. A positive program, policies openly arrived at based on all the available facts, protection from exploitation by unscrupulous groups, active participation by labor in policy formation—these are among the most important measures that may be counted upon to foster within the ranks of labor a high sense of social responsibility.

Monopoly Wages and Prices.

The more the over-all picture is continually laid before the public, by the President, by governmental agencies, and through the process of collective bargaining, the more apparent will be-

come the evils of monopoly, whether labor monopolies or industrial monopolies. If expansionist programs designed to promote a higher level of employment and larger output are dissipated in higher prices, the public will know where the blame lies. In a depressed underemployment situation, monopolies are likely to *hold* prices, and this attracts relatively little notice. Under a program of full employment and increasing demand, monopolies are likely to try to *raise* prices instead of expanding output and employing net additions to the labor force. A full-employment policy, if it is to succeed, must continuously put the emphasis on increased production and rising living standards. Price *increases* are serious obstacles to full employment. A full-employment program must therefore also be an antimonopoly program.

Consumer Interests.

Business must court the favor of consumers as well as establish good relations with labor. It must pay a fair wage, but it must also charge a fair price. Under modern conditions excessive profits cannot for long be maintained by any company. That day is past. A full-employment economy, to succeed, must be a low but *stable* profit economy. Consumer interests balance the labor interest. This helps to promote a sound wage-and-price policy.

Continuous Wage Adjustment.

In some industries it should be possible to include in the collective-bargain agreement provision for a systematic schedule for wage increases based on over-all productivity trends. This schedule should be subject to periodic reviews. There is no good reason why wages should always move upward by leaps and jerks. This movement makes a rational price policy difficult. If a systematic upward-moving schedule of wage increases were instituted, based on the general gains in productivity for the economy as a whole, then also a continuous pricing program could be instituted designed to give consumers their share in exceptional cost-reducing improvements through lower prices. In this manner the interests of the general consuming public, together with the interests of employees, could be met by a continuous process of adjustment equitable to all parties concerned.

Chapter XXI

The Maintenance of Equilibrium

IN A dynamic society the economy is rarely in balance. There is the ever-present problem of steering a middle course between inflation and unemployment.

There are two kinds of programs needed to cope effectively with this situation. The first includes long-range measures under which factors automatically come into play tending to maintain equilibrium. The idea is to set up social mechanisms so constructed that they automatically operate to offset unbalancing tendencies and exert pulls on the economy tending toward stability. The second includes compensatory measures involving continuous adjustment and control.

Automatic Stabilizers.

The long-range automatic mechanisms are very important. Both the unemployment and the old-age insurance systems are good examples. In periods of overemployment, the volume of pay-roll taxes automatically rises and this serves to withdraw purchasing power from the income stream. At the same time, benefit payments decline since fewer are unemployed and old people who have reached retirement may be induced to remain at work or to reenter the labor market. In periods of underemployment the volume of pay-roll taxes declines while benefit payments, especially for unemployment but to some extent also for old age, increase. It is possible, as suggested in the British White Paper on Employment Policy, that a schedule of pay-roll taxes should be arranged on a flexible basis so that they would automatically be adjusted upward or downward according to variations in the volume of employment.

A graduated or progressive income tax has the same automatic compensatory feature. Even though the *rates* remain fixed, the *volume* of tax revenues collected rises and falls more than propor-

tionally with the increase and decline in national income. This has a steadying effect on the flow of aggregate expenditures. Here, also, it would be possible to set a schedule under which the *rates* would automatically vary in relation to fluctuations in income. As a practical matter, a variable structure of rates should probably be limited to the standard or basic income-tax rate.

Another automatic device to steady the flow of income would be a variable schedule of federal grants-in-aid to the states and local governments for public works and improvement projects. The schedule should provide grants that vary inversely with fluctuations in the national income.

The Parker plan for a general reserve fund to be established by local governments is another example of a self-operating automatic device. According to his plan a reserve at the local level would be created by annual deposits, out of taxes, of a given per cent of the authorized budget. Withdrawals from the fund would be based on a formula designed to measure the community's current ability to finance its normal activities. The formula suggested is based on indexes which reflect the impact of prosperity or depression upon the community's fiscal position. In general the plan, if put into operation, would tend to withdraw funds from the income stream during periods of prosperity and to pour funds into the income stream in periods of depression.[1]

Controlled Compensatory Policy.

The more it is possible to implement automatic compensatory devices, the more feasible will it be to achieve economic stability. But the automatic devices will never suffice. Changes in business expectations can come very quickly, and in a free-market economy the cumulative forces can become very powerful within a short period of time. Accordingly, a policy of conscious and controlled compensatory action is absolutely essential. Without it we cannot hope under modern conditions to hold the economy in balance.

In order to achieve maximum results it is important that the controlled compensatory policy shall be explicitly and clearly

[1] For a fuller discussion of the proposal by William Stanley Parker see Alvin H. Hansen and Harvey S. Perloff, *State and Local Finance in the National Economy*, pp 213-214; also Massachusetts State Planning Board. Report of the Committee on Public Works, *A Policy for Stabilizing Public Expenditures* (Mar. 15, 1938).

stated so that businessmen and the public generally fully understand what the program is, under what conditions action may be expected, and what different kinds of measures may be put into operation. What is done must not come as a surprise. Not only must there be a wide understanding of the compensatory program, but there must everywhere be an awareness and expectation that quick action will be forthcoming. The public must also be educated to understand that any program of action that is introduced is subject to change as required by changing circumstances. The government is dealing with a rapidly moving stream of events. Conditions may quickly change, or the first judgment with respect to existing tendencies might, in a few weeks, prove to be wrong. The public should not be surprised if policies are modified or even reversed. It should be widely understood that quick and flexible action—the opposite of dogged determination to be consistent even though wrong—is essential and is to be expected as a matter of course.

Checks and Balances.

At the time Policy No. 1, operating in one direction, is put into effect, Policy No. 2 may be held in abeyance but ready for action if need be to hold in check undue consequences stemming from Policy No. 1. Such a "double-faced" program, looking both ways, is likely to appear inconsistent, contradictory, and confused. But it may be nothing of the sort, and if explained beforehand should cause no surprise. A case in point was the raising of reserve requirements in the inflationary episode of 1936-1937, followed later by open-market operations which tempered the effect of increasing the reserve ratios. I am not here concerned with the question whether raising the reserve ratios was or was not an appropriate device under the circumstances as given. I am concerned only with this episode as an illustration of the validity of combining with the action taken the steadying offsetting open-market operations. Some critics asserted that the Board was obviously confused—by the left hand cutting down excess reserves, and by the right hand increasing them. But this criticism displayed a superficial adherence to formal consistency. When one steps on the gas, it is useful to keep in mind just where the brake pedal is and to use it if and when needed. Indeed, bold action could not be put into

execution if countermeasures were not in readiness to moderate excessive or unexpected consequences springing from any measure designed to accelerate or contract the flow of economic development.

Preparedness.

Not only is it desirable and indeed necessary to make sure that the brakes are in good order when the accelerator is applied; it is also essential that the nation as a whole should constantly be alert to look ahead. It is precisely when undue expansion is going on and restraining measures are being applied that thought should be given to the precise steps to be taken once the tide has turned. There is a strong disposition on the part of many to say that with a postwar restocking boom confronting us, it is nonsense to talk about full-employment measures. But we shall never grow up to our task of keeping the economy on a high and stable level if we persist in concentrating exclusive attention upon the present. It is just during the current period of the restocking boom that the President should make a comprehensive report to Congress on precisely the steps he is prepared to take once a quick cumulative recession, like that of 1937, strikes. There will always be irresponsible people who will be impatient with this procedure. Why talk about antidepressional measures when current forces are inflationary? It will not be possible to manage a stable and expanding economy until the public outgrows the infantile mentality of primitive peoples who refuse to lay up stores of food during the summer because, forsooth, food is currently plentiful. A not inconsiderable part of the press, politicians, and the public are still in that primitive stage with respect to the management of our economy.

Cumulative Process Checked.

Under a planned, forward-looking program of compensatory action, widely understood and anticipated by the public, a powerful secondary stabilizing factor will come into play. With such a program, assuming that it was reasonably effective, the *cumulative* process would lose much of its force. There would be less of a tendency for businessmen and consumers to believe that current tendencies would continue and probably become worse. The

"herdlike" movement, so characteristic of cyclical movements in the past, would be checked.

Yet it is too much to expect, as some have, that a positive compensatory and developmental program would give sufficient stability and buoyancy to the economy to eliminate almost completely cyclical fluctuations in the rate of private investment. The process of cumulation would, it is reasonable to suppose, operate with less vigor and might indeed progressively be largely overcome. But fluctuations would remain. If the secondary and tertiary effects of these fluctuations could be minimized, that would be a great gain. The primary fluctuations in private investment will, however, remain to plague us for a long time to come. Bulges of investment will continue to come and go, even under a comprehensive compensatory and developmental program.

Investment Bulges.

The first basic reason for the continued recurrence of these bulges is the replacement cycle. This has always played an important role. The war has, however, given it renewed significance. An all-out war of modern proportions cannot be waged without giving the economy a terrific "twist." The distortion is most evident in the field of durable consumers' goods and in housing. While not insignificant, it is probably less important with respect to machinery, equipment, and fixed plant. The war has created a violent distortion in the age distribution of automobiles. After the current backlog of demand has been saturated, we shall be confronted with another age distribution of motorcars distorted in the opposite direction. It will take a long time before the age distribution of automobiles becomes again reasonably normal. In the meantime we shall have experienced a number of replacement cycles. In the United States this alone is a sufficiently important factor to cause fluctuations in our economic life which it will be necessary to offset in order to achieve stability.

Add to this the housing bulge. In a few years the private housing market will be largely saturated. Unless we undertake in the meantime a systematic program of demolition of slum and substandard houses, we shall experience a sharp recession in residential construction. The National Housing Agency has suggested a

demolition program of 600,000 units per year, or 15 times the annual rate in the interwar decades. If a program of demolition is combined with urban redevelopment and a support program for the "middle rent" sector ranging from $20 to $40 per month, together with adequate public housing for the "under $20 a month" sector, two decades of stabilized house construction lie before us. Without a well-planned and large-scale housing program, we shall witness violent replacement cycles in housing.

The inventory replacement cycle has had an explosive impact upon economic fluctuations. If it is true that bottlenecks are likely to plague a full-employment economy, inventory bulges will be pronounced unless controlled. Consideration should be given to setting up an Inventory Control Board on a permanent basis. Such a board would normally be engaged in statistical research and the dissemination of information. But periodic inventory investment surges will probably have to be controlled intermittently, or else distortions in production and speculative price movements will occur. It may be necessary, by act of Congress, to empower the President to exercise when he deems it necessary, operating through the Inventory Control Board, to provide priority assistance to producers in order to ensure adequate distribution of limited supplies of raw materials and prevent excessive inventory accumulation.

Investment bulges, moreover, spring from technological developments. Instead of small increments of continuous change, the progress of technique moves in fits and starts, and on occasion huge lumps are tossed into the stream of economic developments. Technological developments may throw up great new industries, causing a bunching of investment. Innovations may produce relocation of industry, redistribution of population, decentralization or shifting of urban populations. All these will create investment bulges. It is simply not possible for investment to proceed on an even course so long as rapid changes in technique, in processes of production, and in products occur. New investment is the advance corps, thrust in, now here, now there, to spearhead the advance of technological progress. This results in a bunching of new investment in fixed capital.

Replacement investment can indeed under full employment be

highly stabilized. In the past it also has fluctuated, owing to the unrestrained cumulative process. This can be corrected. Some new investment, related to growth and expansion, can also be stabilized. But much new investment is autonomous, springing from changes in technique. Such investment will remain largely unruly and will continue to be bunched in accordance with the more or less discontinuous forward leaps made by a dynamic society. Offsetting compensatory action by government is accordingly essential. A sustained developmental program would largely nullify the cumulative cyclical process. This is very important. It may even smooth somewhat the flow of new investment. But it cannot prevent altogether the bunching of pioneering investment arising from changes in technique.

Business Profits and Savings.

The maintenance of equilibrium in a dynamic society relates peculiarly to the matter of business profits and the magnitude of depreciation reserves. It is partly a question of *fluctuations* in the rate of profits and partly a question of the *volume* of gross business savings.

A full-employment economy would tend automatically toward a distribution of income favorable to high consumption. That this is true can be seen if we analyze the problem of corporate profits in a society continually operating at a full-employment level. Peak prosperity profits have never in the past been realized for any considerable period of time. In a highly fluctuating society such as we have known, normal profits were some sort of average of good times and bad times. Thus, in the interwar years, corporate profits fluctuated very violently both absolutely and also in relation to national income. In periods of high prosperity the ratio of corporate profits to national income was high, while in periods of depression the ratio was low. Profits fluctuated far more violently than national income. Over the entire 22-year period, 1919-1940, net corporate profits for all corporations (including those suffering losses) averaged only 4.9 per cent of the national income, and only 3.9 per cent of the Gross National Product. This period included many years of serious depression. Corporate profits averaged less than 5 per cent of a low-average national in-

come—low in comparison with the national income potentially realizable if full employment had been maintained.

In a highly fluctuating society corporate profits are high in good times and low in bad times, but the average must be adequate to motivate a profit economy and ensure its workability. If, however, it were possible to maintain continuously a full-employment national income, it is obvious that corporate profits, representing the same *percentage* of national income as that averaged over the cycle in a fluctuating society, would yield an absolute profit figure far above the experience of 1919-1940. Yet this average percentage continuously maintained would be much lower than the high ratio of profits to national income reached in a few peak boom years.

Peak prosperity profits in 1925-1929 averaged nearly 8 per cent of national income, far above the average for the entire period. In a sustained full-employment economy so high a ratio of profits could not indefinitely be maintained. In a fluctuating society high boom profits are necessary to offset the losses or low profits of depression years. It is a vicious circle. The high profits of the boom, while necessary to provide satisfactory average profits, nevertheless render the depression inevitable. Boom profits induce a volume of savings (retained earnings and individual savings from dividends) higher than the long-term requirements of growth and advancing technique. The high profits of the boom are the inevitable precursors of an impending depression.

In a continuing full-employment economy profits would tend to find an average level—one that could be sustained indefinitely. The past *average* ratio of profits to national income over the entire cycle may be taken as a rough first approximation of a rate of profits commensurate with a normal rate of growth. Boom profits represent a distorted income distribution. Under a sustained full-employment economy, excessive profits would be eaten into, partly by the pressure for higher wages and partly by competitive or otherwise-induced price decreases benefiting consumers. Either or both developments would tend toward a balanced distribution of income—not the distorted distribution experienced in the past in full-employment *boom periods*. Nevertheless, in a full-employment economy, profits might constitute the same *percentage* of national income as that *averaged* in the past, while the

magnitude of business profits would be considerably greater owing to the higher sustained level of income.[2]

Higher *absolute* profits, under continuing full employment, are compatible with a lower profit ratio. The removal of serious risks associated with an unstable economy suggests the feasibility of a lower *average ratio* of profits to income than that experienced in the past. At any rate, the disappearance of the distorted income distribution of boom years would represent a major gain toward the achievement of a condition of sustained equilibrium. The maintenance of sustained and stable aggregate demand requires, as Dean Williams has put it, a "high-wage, low-profit economy." [3]

In a society continuously maintaining full-employment consumption can, accordingly, be raised materially through wage and price adjustments. By reason of full-capacity output, profits could still be adequate to sustain and motivate private enterprise—indeed, larger absolute profits should be possible than those experienced *on the average* in a highly fluctuating society.

Depreciation Policy.

Equally important for promoting equilibrium is the matter of depreciation policy. If commodities are overpriced in consequence of excessive depreciation, consumption is restricted below what it might be—the consumption function is unduly depressed. Sustained full employment is a condition that should facilitate an expansionist pricing policy.

Until about 50 years ago depreciation policy had relatively little influence on the prices of commodities. Competition was still largely on a "catch-as-catch-can" basis. Cost accounting and "administrative pricing" had not yet developed to any significant extent. In the competitive tussle one got what one could out of the market, and trusted to enterprise, venturesome promotion, and luck to draw large prizes. It was a dangerous game; losses were suffered right and left and business casualties (*vide* the bankruptcy rates) ran high. There was in general no calculated margin between costs and prices. If one was lucky and smart, one could

[2] See Alvin H. Hansen, *After the War—Full Employment,* National Resources Planning Board, February, 1943.

[3] John H. Williams in *Financing American Prosperity,* Twentieth Century Fund, New York, p. 369.

get enough back from sales to cover out-of-pocket expenses, and enough besides to maintain and enlarge fixed plant, and extra profits besides. But one might not have this good fortune. Many an enterpriser subsidized the consumer. Promotion and experimentation brought both profits and losses. Many industries grew and expanded from plowed-back profits. In such cases, consumers in reality paid for the enlarged production facilities in prices far above unit costs. But in other cases, where capital was invested and lost in the competitive scramble, consumers got goods at below-cost prices.

The growth of the corporate form of business and the development of efficient business management and accounting procedures necessarily led to the adoption of depreciation practices and principles. Without this unit costs could not be determined. The development of depreciation reserves, stimulated by the growth of well-established corporations and the spread of accounting principles, has increasingly resulted in systematic provision for replacement savings.

On grounds of cost-accounting principles and general economic theory, depreciation allowances should be set at a rate just adequate to *maintain* the physical productive capacity of plant and equipment. If it exceeds this rate, and prices are charged accordingly, the consumer is then forced to pay for capital expansion. It is a species of compulsory saving.

There appears to be a tendency, under modern conditions of controlled or administered pricing, for the rate of depreciation to be set not at a point that would ensure the maintenance of the old productive capacity, but rather at a point high enough to provide for growth of capacity without making any net investment financed from net savings. If, indeed, the depreciation rate were adequate to enlarge a firm's productive capacity year by year in proportion to the general rise in productivity in the economy as a whole, *net* savings would not need to be tapped at all. The compulsory savings imposed upon consumers by reason of charging a price high enough to cover the cost of expansion does the trick. If such a practice were generally applied, the improvement and expansion of plant and equipment adequate to take care of advancing technique and population growth would all be financed

from replacement savings; there would be no outlet at all for net savings.

It is a sobering fact that in the entire decade 1931-1940, more than 90 per cent of the investment in producers' plant and equipment taken as a whole was replacement. There was relatively little net investment. *Net* private formation in fixed capital for the decade was only 4.7 billion dollars, while *replacement* capital formation amounted to 54.7 billion dollars.[4] These data tend to support the thesis that depreciation funds, by and large, were adequate not merely to *maintain* productive capacity but greatly to *increase* it. We know that the productive capacity of American industry was enormously greater at the end of the decade than it was in 1930. Were this not so, it would not have been possible for the American economy to have produced the output which in fact it did produce in the years 1941 and 1942—an output achieved almost wholly on the basis of the fixed capital available at the end of the decade. It is true that by 1943 the new war-production facilities had come into use, which helped to swell the high war-peak production. But these were of little importance in 1941-1942. There can be no question that American industry was well equipped with new machinery and new techniques by the end of 1940. During the decade of the thirties nearly 60 billion dollars had been expended in plant and equipment, mainly replacements and renewals. These replacement outlays were sufficient to provide the highly productive facilities which largely made possible the miracle of the war output.[5]

As an illustration, the accumulated investment in the steel industry by the late twenties was 3.8 billion dollars while by 1937 the total investment was valued at 3.0 billions, yet the capacity in the late twenties was only 58 million tons while in 1937 it had risen to 70 million tons. Similarly, in the railroads the capacity

[4] Simon Kuznets, *National Income and Capital Formation,* 1919-1935; also his *National Income and Its Composition,* 1919-1938, with estimates added for 1939 and 1940. See also *Federal Reserve Bulletin,* September, 1945, p. 873.

[5] These facts supply about the only objective tests we have with respect to the so-called "confidence" crisis of investment in the thirties. The amazing growth in productive capacity during this decade offers little support to the thesis that investment in fixed capital was not proceeding at as high a rate as growth and advancing technique would justify. The American economy was not "run down at the heels" by the end of the depressed thirties.

to handle a larger volume of traffic than that handled in the twenties was clearly demonstrated already in 1941-1942. The number of ton-miles of freight traffic was 50 per cent higher in 1942 than in 1929, while the number of passenger miles was 70 per cent higher. By 1944 passenger-miles were 3 times the 1929 level. Yet investment, as represented by the net capitalization of railroads, had fallen from 18.6 billion dollars in 1929 to 16.8 billion dollars in 1943.[6] Faster trains, better organization, and improved techniques are the answer. In the decade of the thirties we were making rapid increases in man-hour productivity. Output per man-hour rose by over 30 per cent in both manufacturing and railroads from 1929 to 1939.[7]

These data point to the conclusion that capital expansion has in part been financed by consumers through the pricing process. If commodities had been priced on a true depreciation cost basis —one sufficient to *maintain* but not expand productive capacity— prices would have been lower, consumer purchasing power would have been higher, the consumption function would have risen, and potential *net* savings could have found a larger outlet for investment. Investment outlets were, it appears, financed in large measure from "savings" drawn from consumers through a high pricing policy.

A Rational Pricing Policy.

This condition, spurred by excess of caution, is not an unnatural one in a highly fluctuating economy. Under continuing full employment it should be possible to institute a more rational pricing policy. Prices should indeed cover costs, including a normal profit rate, but they should not be boosted to include an excessive depreciation rate. Sustained equilibrium on this basis is made more difficult.

Under modern conditions a high-wage, low-profit economy promotes stability and full employment. In the nineteenth century large business profits promoted a high volume of capital formation; under modern conditions large business profits create a dis-

[6] SOURCE: Interstate Commerce Commission See *The Economic Almanac*, 1945-1946, pp. 255-257.

[7] SOURCE: Bureau of Labor Statistics, Aug. 17, 1945. See Senate Committee Print No. 4, 79th Congress, 1st Session.

torted income distribution, inadequate consumption, and unemployment. Less capital formation in relation to income is now needed owing to the decline in the growth of the labor force, and perhaps also to capital-saving inventions. Under a full-employment economy, as we have seen, factors would come into play tending to promote a lower ratio of profits to national income at full-employment levels, and also a pricing system based on a true depreciation rate. To facilitate sustained full employment, the rate of depreciation and the rate of business profits need to be brought into relation with the requirements of continuing equilibrium in a dynamic society. This means a low-pricing policy. The effect would be to pass on to consumers the fruits of technical progress and to promote a high-consumption economy.

Chapter XXII

Debt Management

THE United States public debt, in accord with the President's Budget Message of Jan. 21, 1946, has been reduced to around 260 billion dollars. Gross National Product at around 185 billion dollars (national income at around 160 billion dollars), it is generally agreed, is not an unreasonable expectation in the early postwar years. At current interest rates this would mean an interest charge on the debt of 2.8 per cent of Gross National Product, or 3.3 per cent of Net National Income. Comparisons with earlier years are given below.

INTEREST CHARGE AS PER CENT OF GNP AND NATIONAL INCOME

Year *	Interest charge as per cent of Gross National Product	Interest charge as per cent of national income
1919	1.5	1.6
1939	1.3	1.5
1945	2 5	3 1
1947 †	2.7 (estimated)	3.2 (estimated)

* GNP and National Income are for calendar years; interest charge is computed as of June 30. SOURCE: U S. Treasury Department.

† GNP for 1947 is estimated at 185 billion dollars, National Income at 158 billion dollars, Public Debt at 260 billion dollars, and average interest on public debt at 1.9 per cent.

Interest charges amounting to 3.2 per cent of national income do not present an unmanageable fiscal problem.[1] Nor is this un-

[1] See the competent and statesmanlike article by John A Stevenson, President of the Penn Mutual Life Insurance Company, Philadelphia, in *Finance,* Sept. 10, 1943. Among other things, he gives a table comparing the debt

precedented in modern fiscal history. Indeed, the ratio of debt charges to national income was double this amount (7 per cent) in England after the Napoleonic War and again after World War I. And now after World War II it is just under 6 per cent. While the British debt in 1946 was 30 times the debt in 1815, the increase in national income combined with the decline in the rate of interest prevented any rise in the ratio of interest charges to national income.

On the one side, our ratio of interest charges to national income is small in comparison with British experience; on the other side, our fiscal capacity is much greater than England's because our per capita income is larger. The same tax rates in a progressive tax structure yield revenues proportionally larger if per capita incomes are high.

Public Debt and National Income.

When the public debt problem is stated in terms of interest charges as a per cent of national income, it is not likely to appear intolerable or unmanageable to any reasonable person. If it is posed in terms of 260 billion dollars without relating this figure to national income, it is likely to appear alarming to many, especially to those who have not thought much about the problem. This is not unnatural. Americans are not accustomed to a national debt of this magnitude. It is a new experience. Nevertheless, practically all thoughtful economists will agree that the national debt, properly managed, does not preclude our looking forward as a people to high levels of production and employment and ever-rising living standards. Indeed, along with some disadvantages, there are also, as we shall see, some positive advantages in a public debt. That the public debt is not an unmixed evil was forcefully stated by Alexander Hamilton 150 years ago.[2]

But rising real income cannot be achieved without responsible monetary and fiscal management, including management of the public debt. It is necessary to provide the monetary environment in which technical research, managerial skill, cooperation between

charges and national income in order to provide a basis for viewing the problems involved "in a rational prospective."

[2] *Papers in Public Credit, Commerce and Finance,* by Alexander Hamilton, McKee's edition.

labor and management, and an efficient labor force can operate to increase output and improve living standards. The modern economic system is amazingly productive, but it is also complicated to an extraordinary degree. There is, however, no ground for despair. Perfection is indeed not within reach, never was and never will be. Yet it is, I believe, a fair statement to say that in recent decades we have learned a good deal about how to run our economy. It is not an unmanageable task. And in a significant number of countries, including our own, democracy has achieved a degree of self-discipline and social cohesiveness adequate for the attainment of substantial stability and progress. Among the many difficult economic, social, and political tasks that confront us in the achievement of these goals, the problem of responsible management of the public debt is relatively simple by comparison.

Responsible Debt Management.

There are four basic principles of responsible debt management: (1) government securities must be made a safe and dependable investment, promptly repaid at maturity and readily convertible into cash; (2) the value of money must be maintained, avoiding both inflation and deflation; (3) the public debt should be held as widely as possible by the entire citizenry so as to promote, in conjunction with a progressive income-tax structure, an equitable distribution of income; (4) the budgetary control of federal expenditures, taxes, and borrowing should have as a primary objective a continuous growth in the real national income. In short, dependable government bonds, stable money, widespread ownership of the national debt, and a full-employment fiscal policy—these are the essential elements of a sound and responsible program of debt management.

The first principle is well illustrated in the history of England. The year 1688 marks a turning point in British financial history. Thenceforth, for the first time in modern history, the public debt became a secure investment. This fact is one of the most significant institutional developments of modern times.

The British public debt, since 1688, has played an important part in the development of her financial institutions. The Bank of England, established in 1694, had its origin in, and throughout its subsequent history was intimately connected with, this wholly

new development of public debt. The year 1688 was the year of the "Glorious Revolution." Constitutional government took firmer roots. The national debt was no longer simply an affair of the monarch's. Formerly kings had borrowed from private money-lenders, paying exorbitant rates of interest which led time and again to repudiation of the debt. This had occurred, for example, under Charles II in 1672. Now under William of Orange, and the establishment of the Bank of England, the public debt became a truly *national* debt; not the debt of a capricious monarch liable to repudiation. It became a debt for which the whole nation was responsible, and in which merchants, traders, capitalists, and property owners in general found a safe and dependable financial investment.

This represented a great change. The Bank of England from its inception issued notes based on its holdings of Government securities. The bank indeed took its origin in a loan of £1,200,000 to the Government. This was the beginning of the modern interconnection between the treasury and the banking system. Under it governments do not print money directly. The money (whether currency notes or demand deposits) is created by the banking system in exchange for government bonds. Modern governments finance themselves (1) by taxation, (2) selling bonds to the public, (3) selling bonds or short-term securities to the banking system. The banking system, through public ownership or government control of the central bank (in the United States the Federal Reserve System) everywhere works in close collaboration with the treasury. Just as the Bank of England was established to help finance the Government, so now in all modern democratic countries much of the public debt is held by the banking systems. Through control of the central bank, and thus indirectly the control of the money market, no well-established government such as the United States, Canada, or England has to worry about whether it can market its bonds. The financing of the war has demonstrated this on a tremendous scale.

The question is often asked, "Where is the money coming from?" About this there is no problem. The problems (and they are real ones) are quite otherwise. The real problem, whether in war or peace, is to set productive resources to work—capital, labor, skill, and technique. If a total war must be waged, the money must

indeed be raised. But that presents no difficulty. What cannot be raised from taxes or borrowed from the public can be obtained from the banks. The banking system *creates* the money outright by crediting the government with demand deposits. The very ease of the operation, however, calls all the more for skill and a high sense of financial and fiscal responsibility.

To get the money is easy. But to control the money supply and the public debt that lies back of it, that is the problem of monetary and debt management. And it is a problem that confronts every modern country.

Under the exigency of the war, things had to be done that would not be done in peacetime. The war financing is now water over the dam. While in some measure a better balance could have been reached between taxation, borrowing from the public, and borrowing from the banks, nevertheless the job was sufficiently well done in the leading democratic countries for the postwar monetary and debt problem to be thoroughly manageable.

Mismanagement could of course wreck us. That is the nature of our modern world no matter in which direction one looks. Our scientific knowledge is now by far our richest treasure. But we have become painfully aware that science may become a dangerous resource. Primitive people were in danger of disasters arising from natural forces that they could not control—pestilence, floods, famines, etc. Modern nations are in danger of the irresponsible use of the institutions man has created. This is true not only with respect to politics and economics, but also with respect to our mastery over nature.

Since 1688 England has learned to manage her public debt. The debt has never been repudiated. It has not destroyed the internal value of the monetary unit. Over the centuries it has grown, but never to proportions unmanageable in relation to national income. It stood at £21,000,000 in 1697, £75,000,000 in 1755, £257,000,000 in 1786, £848,000,000 in 1815, £7,830,000,000 in 1918, and £24,500,000,000 in early 1946. But the debt charges *in relation to income* are somewhat lower today than in 1918 or 1815.

For the United States two matters especially concern us: (1) How is the *ownership* of the debt distributed, and how does this

affect the distribution of income? (2) Is the *volume* of total liquid assets now held in this country too large for safety?

Distribution of Bond Holdings.

Who owns the government debt obligations and who pays the taxes required to service the interest on the debt is a matter of great significance. As I have repeatedly pointed out (see Chap. IX on the "Growth and Role of Public Debt" in my *Fiscal Policy and Business Cycles* and subsequent publications, including my "Reply to Moulton," Appendix A in *State and Local Finance in the National Economy*), it is not true that the public debt doesn't matter. No economist, so far as I know, has taken this position. It is indeed tremendously important for a country with so large a debt as ours that the bonds belong to our own people, that the interest payments flow back to American citizens and American business and financial institutions. But this fact does not render the debt of no account. It *is* important that " we owe it to ourselves" and not to some foreign country, but it is also important *who* among us holds the bonds, and *who* pays the taxes.[8]

[8] In a matter as complicated as the problem of the public debt, isolated phrases quoted out of context can yield almost any desired result. This is illustrated by the following amusing letter received from a friend. It read as follows:

"Using Dr. Moulton's method of partial quotation one can get this apparent summary of the Hansen-Moulton debate:

> "Hansen: 'In time of depression and readjustment public outlays not covered by taxes may be . . . essential . . . in stimulating recovery. . . . Students of public finance are . . . agreed . . . that there is no necessity of reducing a public debt to zero. Many countries have had public debt for a century or more. . . . At a time when . . . the national income is steadily rising, with the tax-paying capacity likewise increasing, a country would obviously be able to support an increasing public debt. . . . It has long been recognized and repeatedly pointed out that there is an essential difference between a domestic public debt and an external public debt.'
>
> "Moulton: 'The above statement . . . is . . . an oversimplification. . . . A too rapid increase in loan expenditures . . . will produce inflation. . . . A large debt in relation to national income may imply a disproportionate amount of wealth . . . held by the wealthy classes. . . . Even an ideal tax structure will restrain more or less the inducement to invest. . . . There are limits to the public debt which, if exceeded, will . . . affect the workability of the economy.'

"But in fact the passages attributed above to Hansen come from Moulton (*The New Philosophy*, p. 50 *et seq*), and those attributed to Moulton come from Hansen (*Fiscal Policy*, p. 174 *et seq.*). *Res ipso loquitur!*"

These considerations were well stated in the Annual Report of the Secretary of the Treasury to the Congress, Jan. 3, 1945:

"The payment of interest is a transfer operation by which the amount of interest is collected from taxpayers and paid to the holders of the debt, who are also numbered among the taxpayers. The burden of the debt, therefore, consists of the necessity of collecting a large amount of money from some persons and repaying it to others, and of the possible adverse economic effects of the resulting redistribution of income upon the amount of the national product."

On Nov. 1, 1945, the total interest-bearing securities of the federal government were held as follows—figures are in billions of dollars:

U. S government agencies and trust funds	26.8
Federal Reserve Banks	23 3
Mutual savings banks and insurance companies	32.6
Commercial banks	84 2
Other investors (individuals, business, state, and local governments)	93 2

Let us try to break this down a bit further in order to see how the debt affects the distribution of income. Is the debt largely held by a few rich individuals and large business corporations, or is it widely held by the mass of the citizens either directly in savings bonds or indirectly by savings and financial institutions serving the broad interests of the whole country?

Government Funds and Savings Institutions

The 82.7 billion dollars held by United States government agencies and trust funds, the Federal Reserve Banks, and the Mutual Savings and Insurance Companies—the first three categories listed above—tend toward diffusion of wealth and income. The bulk of the first item (United States agencies and trust funds) supports the old-age, unemployment, and other social-insurance systems. Any profits made by the Federal Reserve Banks above operating costs are in the final analysis subject to capture by the federal government. The holdings of mutual savings banks and insurance companies constitute an important part of the assets safeguarding small savings accounts and life-insurance policies broadly held throughout the nation.

Of the 93.2 billion dollars held by "other investors" 34.3 billion dollars were Series A-E bonds, the ownership of which was largely diffused among the people as a whole.[4] Of the remaining 58.9 billion dollars, about 30 billion dollars were held by business concerns, corporate and unincorporated; about 5 billion dollars by state and local governments; while the rest (nearly 25 billion dollars) was presumably held largely by wealthy and well-to-do individuals. The holdings by business concerns, it will generally be admitted, have an important bearing on business stability, employment, and production. There are, to be sure, certain knotty problems involving questions relating to corporate taxation, the effect of these holdings upon future investment outlets for net current savings, etc. Nevertheless, by and large the picture presented by the distribution of the holdings by individuals and corporations cannot, I am convinced, support the thesis that inequality in income distribution has been intensified by the wartime increase in the public debt. This conclusion is reinforced when consideration is given to the character of the federal tax structure.

Bank Holdings.

There remain the 84.2 billion dollars held by the commercial banks. It is probably true to say that this item is the cause of greatest concern. There is a widespread feeling that the banks hold too many bonds and receive too much interest. There is even some considerable feeling that they are not entitled to this interest. These latter questions have been discussed elsewhere in this book. Here attention will be centered on the effect of these holdings on income distribution.

A Small Country Bank.

I have before me a statement of the conditions of a small country bank as of Dec. 31, 1945. It is typical of the situation of innumerable country communities throughout the country. In a slightly abbreviated form, the statement of assets and liabilities was as follows (in thousands of dollars):

[4] Possibly about one-third of these savings bonds are held by the well-to-do and wealthy classes.

Assets		Liabilities	
U. S. government securities	1,164	Deposits	1,672
Cash	401	Capital and surplus	74
Loans	149		
Other assets	32		
Total	1,746	Total	1,746

Almost the entire earning assets of this bank consist of government securities. Loans to farmers and local businesses are nearly nonexistent. The reason for this is obvious. The citizens of the community hold liquid assets, including deposits in the bank. But these deposits are not offset by debts owing to the bank. These deposits represent accumulated savings. With ample liquid funds, there is no need to borrow from the bank. This community has no occasion to feel badly about the government securities held by the local bank.

Formerly the bank statement in this and similar communities looked very different. The deposits were largely offset by loans. Interest was paid to the bank on these loans. Today such interest payments have been reduced almost to the vanishing point. Instead, the members of this community now contribute something in federal taxes to the interest paid by the government on the securities held by the local bank. Taking account also of the savings bonds held by the citizens themselves, and the relatively low federal taxes paid by farming communities, it is difficult to believe that this community is making a net contribution, by reason of the public debt, to the income of "bloated bondholders."

Farmers' Savings.

The table on page 270 presents the financial status of the American farmer in 1945 compared with 1940.[5]

Accordingly, farmers have moved in 5 years from a net excess of nearly 5 billion dollars of debt above liquid assets to a net excess of nearly 8 billion dollars of liquid assets over debt, a net gain of around 13 billion dollars. It requires very little sophistication in monetary and fiscal matters to see that this improvement in the financial position of farmers is, among other things, intimately connected with the growth in the federal debt.

[5] SOURCE: Bureau of Agricultural Economics, U.S. Department of Agriculture.

(In millions of dollars)

	1940	1945
Liquid assets		
Deposits and currency	4,030	11,600
U. S savings bonds	247	3,910
Other	966	1,278
Total	5,243	16,788
Debts		
Real-estate mortgages	6,586	5,271
Other debt	3,396	3,681
Total	9,982	8,952
Margin of liquid assets over debts	−4,739	+7,836

Savings of Individuals and Business Units.

A comprehensive view of personal holdings of liquid assets, together with those of business (nonfinancial) concerns from December, 1939, to December, 1945, can be obtained from the table on page 271.

Estimates of total accumulated savings of individuals (nonbusiness), including currency, deposits and government securities, funds accumulated back of insurance policies, postal savings, and net savings and investments accumulated by individuals in savings and loan associations, amounted to 73.9 billion dollars in December, 1939, and 186.7 billion dollars in December, 1945.[6]

At the same time that liquid assets have increased, the financial condition of individuals and business has also improved by reason of widespread debt reduction. Farm-mortgage debt has declined from 9.4 billion dollars in 1930 to 5.3 billion dollars in 1944, while urban real-estate mortgages have declined from 33.1 billion dollars to 27.2 billion dollars. Corporate long-term debt has fallen from 51.1 billion dollars in 1930 to 40.9 billion dollars in 1944.[7] All these data indicate an unprecedented general improvement in the financial position of farmers, urban citizens, and business concerns.

It is true that the two experimental surveys of liquid-asset hold-

[6] Institute of Life Insurance, 60 E. 42d St., New York.

[7] *Survey of Current Business,* September, 1945.

(In billions of dollars)

	Personal *	Business: corporate and unincorporated †
December, 1939: ‡		
Currency..	4.2	1 6
Demand deposits	8.0	12.9
Time deposits	24.3	2.0
U. S. government securities	8.9	3.2
Total	45.4	19.7
December, 1945: ‡		
Currency	21.1	4 9
Demand deposits	23.6	37 8
Time deposits	45 1	3.1
U. S. government securities	55 7	34 0
Total	145.5	79 8

* This includes personal trust funds. These increased their holdings of liquid assets from 4.5 billion dollars in 1939 to 16.5 billion dollars in December, 1945; holdings of United States securities were 3.1 billion dollars in 1939 and 14.7 billion dollars in 1945.

† This includes financial corporations. These increased their holdings of liquid assets from 1.7 billion dollars in 1939 to 4.9 billion dollars in December, 1945.

‡ *Federal Reserve Bulletin*, February, 1946.

ings made by the Department of Agriculture in Birmingham, Ala., and in Douglas County, Ill., indicate that the lower half of the population, in terms of income status, have accumulated relatively little in liquid assets. Thus in Birmingham 59 per cent of the respondents had acquired only 19 per cent of the war bonds held by the group; while in Douglas County 50 per cent of the urban respondents had acquired only 15 per cent, and 49 per cent of the farmers questioned had acquired only 23 per cent of war bonds purchased by the respective groups. But this will not surprise anyone who has studied even a little into the past record of the distribution of wealth and income. There is no evidence in these figures, tentative as they are, that income distribution is more unequal than formerly by reason of the great growth in liquid assets.

Is It a Fool's Paradise?

Apart from the *distribution*, consider the *magnitude* of the current liquid assets. The war has made us rich, at least in terms of holdings of bonds, currency, and deposits. But is all this perhaps fictitious? Have we become too rich in *monetary* liquid assets? Are we living in a fool's paradise?

The huge liquid assets which have enriched the public—individuals and business—are mainly a consequence of the increase in the public debt. Every increase in the debt means an increase in the volume of cash and bonds held by the public. If the new issues are purchased by the public (nonbanking investors), this means that privately held deposits are turned over to the government in exchange for bonds. So far there is no increase in total liquid assets held. But the government draws checks against the deposits in payment for war contracts or other government outlays, and so the deposits quickly get back into the hands of the public again. The liquid assets held by the public rise, since there is the same volume of deposits as before, and besides, there is the new acquisition of bonds. If, on the other hand, the new issues of government securities are sold to the commercial banks, the government is credited with new additional deposits. When the government spends these funds,[8] the deposits come into the possession of the public. Thus in this case the *cash* holdings of individuals and corporations rise. Either way, whether the government borrows from the public or from banks, the liquid assets are increased, securities in the former case, cash holdings (deposits or currency) in the latter case.

It is therefore a simple matter to enrich a community in monetary terms. All you need to do is to make loan expenditures, and this can be done by reducing taxes no less than by increasing outlays. The counterpart of the rise in the public debt is the increase in the public holdings of cash and securities. But money has value only as it gives command over goods and services. Thus we *may* be living in a fool's paradise.

[8] The deposits are transferred by the Treasury to the Federal Reserve Banks, and checks are then drawn against these deposit accounts. These checks are paid out to contractors and others who sell goods or services to the government These checks are then deposited in the commercial banks.

The question whether this is or is not the case depends upon our capacity to turn out year after year a volume of output that will give *real value* to the flow of current money income as well as to the *liquid-asset holdings* of the public. This is the all-important question. If we can produce a Gross National Product in the next 5 years in *physical* volume equal to around 180 to 200 billion dollars of goods and services *measured in* 1945 *prices,* then I think we shall find that our liquid assets have real value. A flow of physical goods and services of this volume, year in and year out, means that demand is being matched by a vast and continuing supply. Under these circumstances we should be able to prevent any inflationary development. We should be able to preserve the value of money, whether the money currently earned or the money held as a liquid asset.

Balance between Money Wealth and Real Wealth.

The ease with which it is possible to build up large liquid-asset accumulations in the hands of the public emphasizes the folly of permitting a condition of inadequate aggregate demand such as prevailed in the depressed thirties. But it also illustrates the need for responsible fiscal management—the control of expenditures, taxes, and borrowing so as to preserve the value of money. Sound fiscal policy requires the prevention both of inflation and deflation.

Most of the occupied countries of western Europe have come out of the war with an enormous excess of liquid assets. But they are not rich. And the reason is that their economies can't produce goods at all commensurate with the monetary assets. With production far down and monetary assets far up, inflation is inevitable. To cure this situation they must deflate their monetary and other liquid holdings and they must increase production. But it makes no sense to carry this process too far. There are still too many people who think it is sound finance to create a deficiency of liquid assets and monetary purchasing power, thereby bringing on deflation and unemployment. But deflation is no less an evil than inflation. It is always necessary to strike a balance.

In the United States we have fought a great war without any substantial price inflation. The price level was abnormally low for agricultural products in the depressed thirties. They are now

somewhat too high, and can be expected to settle down to a more balanced relation with other prices in a year or two as soon as the current food shortage is overcome. The purchasing power of money is only moderately below the predepression level of the twenties. Having come through the war, after a great effort, with substandard price stability, we should be foolish to lose the battle now. We must safeguard our accumulated savings from being dissipated by a fall in the purchasing power of money.

Six Policies to Control Inflation.

To this end six policies are necessary during the period of the restocking boom: (1) continuation of price control until we have overcome the temporary war-created scarcities; (2) rapid increase in the production of houses, consumers' durables, and clothing; (3) a balanced adjustment of wages in relation to man-hour productivity without pushing wage rates so high as to necessitate a general over-all increase in prices; (4) continued high taxation; (5) a continued program of saving by the entire population with special emphasis on the purchase of savings bonds; (6) application by the Treasury of funds derived from the public's purchase of savings bonds to the retirement of government securities held by the commercial banks.

If such a program is even reasonably well undertaken and supported by responsible leaders throughout the nation, the people as a whole can be expected to act in a sensible manner. The survey of liquid-asset holdings by the Department of Agriculture [9] indicated that the holders of wartime savings are not inclined to spend them recklessly. There is a tendency to think of these liquid assets as a source of economic security or as a means of financing investment-type purchases rather than as a means of financing the purchase of consumers' goods. This attitude could of course change, but the evidence to date is that the wartime savings are on balance firmly held. The same conclusion was reached in a savings survey published by *Fortune*, November, 1945. War-savings bonds in large volume are indeed being cashed but typically for very sensible reasons; on the other hand, new purchases continue on a large scale. The President, in his Budget Message, stated that the issuance of savings bonds will be continued. These

[9] See *Federal Reserve Bulletin*, September, 1945.

bonds represent the most convenient and safest method of investment for small savers, especially through the medium of voluntary pay-roll deduction.

If we protect our wartime savings from being dissipated during the period of the restocking boom until the accumulated shortages have been overcome, they will stand us in good stead as a cushion against deflation. In view of the current temporary scarcities, the high volume of liquid assets *could* be mismanaged. In this period of war-created shortages they do present dangers. But in the long run, if we safeguard them, they will prove a bulwark of protection against inadequate monetary purchasing power.

A large public debt means large liquid assets in the hands of the people, whether in the form of deposits (if the debt is held by the banks) or in the form of bond holdings (if the debt is held by the public directly). Thus a public debt, widely held either directly or through financial institutions, amounts in effect to a kind of national insurance system to which most of us contribute by paying taxes and from which insurance pool most of us receive benefits in the form of interest payments directly or indirectly. But the really essential part of this insurance system is the fact that the owner of the bond can sell it or use it as collateral to meet unforeseen contingencies. But while some individuals will, and should when necessary, spend their liquid assets, others will add to their holdings. The great benefit gained by society as a whole is security—command, when needed, over goods and services. And the ultimate security lying back of these assets is our capacity as a nation to produce a high volume of goods and services.[10]

Liquid Savings and the Public Debt.

The general desire to hold on to our wartime savings on top of our holdings of private equities and privately issued securities is evidence that the public really does not wish to retire the public

[10] The superficial argument is sometimes made that the public debt has no real value because there is no tangible wealth behind it. This view is a hang-over from primitive conditions when property claims consisted of direct ownership of a tangible good. In modern communities, however, it is the power to produce real income (goods and services) that gives value to all property claims, whether private equities, private debt, public debt, or money itself.

debt. We all like our bonds and other liquid assets and we mean to keep them.

It is evident from what has been said above that the public debt, with respect to both its size and its distribution, has a profound effect upon the economy. It *can* have adverse effects upon production and employment resulting from the redistribution of income due to the manner in which the debt is held and how taxes are collected. It *can* have adverse effects if it grows to a size, in relation to real income, so large that the holdings of liquid assets become inflationary. It is important that the volume of production—the flow of goods and services which constitutes the real income of the nation—shall be adequate to give real value to the liquid assets to which the debt gives rise. It is precisely problems such as these that call for responsible debt management.

Debt in Relation to Income.

Professor A. P. Lerner has taken me to task because I hold that account must be taken of the "magnitude of the public debt in relation to other magnitudes, especially of the public debt to national income." [11] Lerner regards this type of argument as either a failure to see the full logical implications of the new fiscal theory or else as evidence of oversolicitousness to save the public from the necessary mental exercise—in short, an effort to "appease," as he puts it, established prejudices.[12]

Lerner asserts that the "absolute size of the national debt does not matter at all." This is one of his "shocking" statements in which he seems to take great pride. But as a matter of fact, he

[11] See Alvin H. Hansen, *Fiscal Policy and Business Cycles,* p. 174.

[12] See A. P. Lerner, *Social Research,* February, 1943, and reprinted in *International Postwar Problems,* October, 1945. Lerner thinks that the "method of appeasement," as he charges, has led to extremely effective opposition Indeed he himself states some of the popularly superficial arguments as though he thought them unassailable. Thus he asserts that on my terms "the debt will keep on growing until it is no longer in a 'reasonable' ratio to income." Yet his own subsequent argument shows that this is not the case. He states that the needed taxes incident to the rising debt will discourage risky investment, the inference being that this is an "effective" argument against my position. Yet he himself shows that taxes need not be unduly repressive, and that "as the national debt increases . . . there will be an increasing yield from taxes on higher income and inheritances, even if the tax rates are unchanged."

quickly qualifies it. "Having made his sweeping statement, he then begins to introduce limiting criteria. He explains that certain conditions *are* of serious consequence to the economy, that they must not be allowed to develop, and that they *are* or *may be* brought about by reason of the *growth* or *magnitude* of the debt. Thus, according to his own analysis, there are after all "limits" to the debt. What this means must be adjudged in terms of Lerner's own criteria. For example, taxes must be collected under certain conditions in order to prevent inflation (and taxes impose limits on the debt). Thus it turns out after all that the debt must be kept in a "reasonable" ratio to income. Of course Lerner's hypothetical debt figure (10 trillion) is certainly not in reasonable relation to income as he himself admits. And why? Because long before this point is reached, privately held liquid assets would be so great that current "private spending" would create inflation unless all government outlays were financed from taxes. But this would mean that the debt could not be allowed (on Lerner's criteria) to rise. It would already have reached a "limit," beyond which it would be "unreasonable" to go. What now becomes of his statement that there is no *"limit"* whatever to the debt? He has himself shown that there *are* "limits." What do "criteria" mean except signposts of "limits"? Indeed Lerner guesses that "limit" (as I would not) at "100 to 300 billions." Does this mean that he thinks the debt is already so high that a balanced budget is necessary in normal peacetime years to prevent inflation?

It is also evident from what is said above that his "shocking" statement that "interest does not have to be raised out of current taxes" also vanishes as soon as the criteria of *inflation* are applied. Federal expenditures in the postwar in the United States will certainly be so high that if taxes do not exceed the interest payments on the debt (5 billion dollars or so), we should experience inflation.

In addition to the "limit" on national debt imposed by the criteria of inflation is that of concentration of wealth. Lerner's 10 trillion is fantastically beyond the "limit" that this criterion imposes. Thus, again, there is a "reasonable limit" to debt.

Finally, there is the "limit" imposed by the criterion of "appropriate interest rate." Whatever the desirable rate of interest 20

years hence, it would clearly, I think, be disturbing to allow a rapid fall in the rate.[13] This involves *control* of the rate of borrowing and taxation; and this "control" will affect the size of the debt. Thus, again, this criterion (by determining the desirable rate of taxation or borrowing) imposes a "limit" on the debt.

Since Lerner's own criteria for control require taxes, he feels compelled to assert that taxes don't matter, that they are "merely" transfers like interest you "pay your wife," that they "need not discourage investment," etc. Now these statements are certainly exaggerated and not defensible in unqualified form. Indeed, he himself admits that *some* qualifications are necessary. He admits that complete Treasury sharing of losses is not permissible. True, we *can* allow loss offsets against profits, and that helps a great deal to reduce the restrictive effect of taxes on new investment. But one can then no longer make the sweeping statement that taxes do not matter at all.

On the "merely transfer" argument Lerner seems to admit no qualification whatever. But with respect to his "10 trillion" debt, he forgets that a young man starting a business (who has accumulated no bonds) would have to pay a tax (if his income is in the mean bracket) of two-thirds of his income merely to pay interest on so vast a debt held by others. Lerner might say that the tax to pay interest could be applied *only* to income from bonds. But that would amount to complete tax confiscation of the income from bonds, and at least he does not suggest it. (Kalecki's capital tax in practice comes very near to this if real estate is omitted.) It is simply not true that a tax is "mere" transfer and has no effect. The tax "burden" is part and parcel of the "distribution of wealth" criterion which Lerner admits does impose a "limit" on debt in relation to income.

That my criterion of a "reasonable" ratio of debt to income may defeat the ends of fiscal policy (as Lerner infers) is not true, as his own analysis shows. He has mentioned, but he does not stress as I think he should, the fact that a full-employment program in view of growth (1) in labor force and (2) in productivity

[13] In *Financing American Prosperity* (p. 254) I said: "What the desirable level of interest rates may be a decade or so hence, I do not pretend to know, but for the years ahead, I think we would do well to stabilize around present levels." This of course refers to the gilt-edged long-term rate. The rate on home-mortgage financing should be reduced.

should give us an ever-rising income. Thus, even though interest *rates* do not fall, tax rates needed to finance debt interest might well be *reduced,* the more so if the tax structure is progressive.[14] If interest rates fall this would be still more the case. Thus an ever-growing debt would not, within the limits of what is probable, necessarily mean higher *tax rates.* If higher tax rates prove to be necessary, the problem is not unmanageable, but it is nonetheless still a problem.

The Debt and Income Distribution.

A number of very interesting reflections on the impact of the debt upon income distribution are brought out in Mr. Wallich's [15] able paper on "Public Debt and Income Flow" in the *Federal Reserve Postwar Economic Studies.* While doubtless it is extremely difficult to make any accurate statistical appraisal of the impact of the debt on the income flow in terms of (1) the distribution of bond holdings, and (2) the tax structure which finances the interest charges, nevertheless I think the attempt he makes is illuminating. For one thing, it stresses a point frequently overlooked, that the net tax burden incident to the public debt is considerably less than the total interest charges in view of the fact that the holders of the bonds will pay a considerable tax (about a billion dollars in 1948) on the interest earnings received. Moreover, in terms of the disposal of the interest payments as between saving and expenditures, the data point to the conclusion that the net deflationary effect of the total transfer from taxpayer to interest recipient is relatively small. To be sure, the conclusion as Mr. Wallich states it does not take account on the one side of the contractionist effect of the impact of the added net tax burden upon new investment and new industry, nor on the other side of the expanionist effect of increased liquidity and financial security upon the propensity to spend out of current income. After taking account of all factors, I think it is highly probable (and this seems to be the general view one gains from financial writers) that the net effect of a large public debt is likely to prove, on balance,

[14] See N. Kaldor, Appendix C in Beveridge's *Full Employment in a Free Society.*

[15] See *Public Finance and Full Employment,* No. 3, Postwar Economic Studies, Board of Governors, Federal Reserve System, December, 1945.

expansionist. Indeed, during the restocking boom, as already noted above, its expansionist effect must be held in check by a high rate of taxation. After the restocking boom is over, the debt is likely to make the postwar employment problem easier, not harder.

Monetary Control and Property Claims.

There are indeed problems of management arising out of the very large volume of liquid claims resulting from the large public debt. As Mr. Wallich points out, much the same type of monetary-control problems would result from an equivalent increase in property claims arising from a private creation of debt and other property claims. Yet I think Mr. Wallich has confused the problems of a high-income society with those of a society rich in terms of large holdings of liquid assets. A high-income society tends, on balance, to *save* a large part of its current income; on the other side, one with high liquid assets tends, on balance, to *spend* a large part of its current income. Indeed, the tendency toward oversaving of a high-income society can, in no inconsiderable measure, be overcome by fiscal policies that cause such a society to become also rich in its liquid-asset holdings. The more liquid the society, the more it will tend to become a high-consumption society.

Excess Money Supply.

Mr. Wallich makes a rough calculation of the probable excess in the money supply in 1948. He probably does not sufficiently recognize that the term "excess" can have no precise meaning unless one assumes a given rate of interest. A high degree of liquidity will result in a low rate of interest, and at that rate of interest the money supply may not be in excess. A truly excessive money supply would tend to disappear since such a condition would induce investors to give up liquidity in exchange for securities. One could, of course, say that the money supply was so great that it produced a rate of interest so low as to stimulate an undue expansion and in that sense the money supply was "excessive."

In discussing the alleged "excess," Mr. Wallich says that we are likely, in fact, to eliminate it by gradually growing into the money supply; but this process, he says, would take several dec-

ades. This seems to be unduly pessimistic with respect to the probable growth of real income. In our past history it appears that our Gross National Product has doubled every 20 or so years. If we maintain anything approaching this rate of growth, we should in a very few years reach the "normal" ratio of income to money supply and indeed before very long we should need further increases in the money supply. But this part of Mr. Wallich's discussion again is rather unsatisfactory in that it fails to define what this "normal" ratio is and how it relates to the level of the interest rate. In the section immediately following Mr. Wallich does call attention to the fact that liquidity is a factor in keeping interest rates low, but he does not seem to have integrated this analysis with his previous remarks.

In connection with the long-run need for an increase in money supply, as real income rises, one faces up squarely with public debt policy and in particular with future increases in the debt financed by borrowing from banks. Under modern conditions when commercial loans are relatively negligible, an increase in the money supply adequate to maintain high liquidity and low interest rates could hardly be achieved without government borrowing from the banking system (unless, indeed, straight currency issues are resorted to as advocated by those who favor interest-free financing). This is a matter that deserves much more discussion than it has thus far received.[16]

Pay-roll Deduction.

Mr. Wallich suggests that so long as the threat of inflation persists it will be desirable to continue the pay-roll deduction system for purchase of Series E bonds, but that if contractionist tendencies appear, it will be better to scrap the system. It is hardly possible that these pay-roll deductions could be used in any systematic way as a cyclical device. If unemployment was increasing, those still employed would probably wish to save all the more. As a long-run measure, a continuation of the pay-roll deduction system might indeed operate rather seriously to reduce the ratio of consumption expenditures to income payments. This would have a deflationary effect upon the economy. To overcome this tend-

[16] See in this connection Chap. XIII in this book.

ency and still retain the benefits of individual thrift, a part of the federal budget could be financed from the pay-roll deductions (thrift bonds), thereby permitting a reduction of the basic income-tax rate. By this method we would encourage thrift and raise the level of financial security for the mass of our citizens and at the same time prevent the deflationary effect of such pay-roll deductions upon consumption and aggregate demand. The increasing achievement of financial security would, moreover, progressively tend to raise the propensity to consume.

I have mentioned above the possibility of combining the pay-roll deduction savings plan with a reduction in the standard income-tax rate. Professor Haberler has recently called attention to the advantages in what he calls the "revenue method," [17] namely, tax reduction as a means of increasing total effective demand. He deprecates "the idea, now gaining in popularity, that aggregate effective demand can be stimulated sufficiently to eliminate unemployment by increasing public expenditure *without deficit financing.*" He calls attention to the now generally admitted fact that in order to achieve a given increase in aggregate outlays, public expenditures must be increased more if they are financed by taxes than if they are financed by loans. He doubts, as an antidepression policy, the wisdom of tax-financed expenditures as compared with deficit financing. He concludes with this statement: "This may sound paradoxical to many, for what most conservatives are afraid of is a deficit and a growing public debt. Their obsession with the public debt may thus lead them into a much more dangerous alley." While Professor Haberler is directing his statement mainly to antidepression policy, his analysis may (under certain conditions at any rate) be equally applicable to longer run considerations.

Four Elements in Debt Management.

Fiscal policy involves the control of expenditures, taxation, and borrowing. And this broadly affects the size of the debt and the distribution of wealth and income. Fiscal policy thus consists in considerable measure in debt management, broadly conceived. In a more specialized sense, however, debt management involves control of (1) composition of the debt in terms of the relative volume

[17] *Review of Economic Statistics,* August, 1945.

outstanding of Treasury bills, certificates of indebtedness, 3- to 5-year notes, and bonds of varying maturities, (2) the relative holdings of government securities held by the banks and by the public, (3) the supply of money (currency and deposits), and (4) the structure and level of the rate of interest. All four are closely interrelated.

Bank vs. Nonbank Holdings.

If the banks absorbed all the national debt, inducing the public to sell their holdings by bidding up the price, the yield on bonds would fall very low, interest rates in general would fall, and the public would hold their liquid assets entirely in cash.[18] Such a development would be strongly inflationary. Contrariwise, if the banks unloaded their holdings of government securities on the public, bond prices would fall, interest rates rise; the public would hold more government securities and less cash. Bank assets and deposit liabilities would decline; the money supply would fall drastically.

These extreme developments are of course wholly improbable. The banks will not wish to sell securities unless they can find a more profitable alternative outlet for their funds—commercial loans, for example. Some expansion of loans there will be, but small. Unless restrained by increased reserve requirements, banks will wish to retain their holdings of the public debt. And on balance the public as a whole is not likely, in view of the large current holdings of currency and deposits, to reduce its net holdings of securities. If the public sold bonds to the banks, the public would acquire still more cash. The proportion of cash to securities is already very high.

[18] The fact that the commercial banks have been permitted (indeed induced, by the Reserve Banks providing them with excess reserves) to compete in the market for government securities is responsible for the low rate of interest achieved in the financing of the war. New borrowing *during the war* has been done at an average rate of 1 8 per cent, while the average rate in World War I was around 4¼ per cent. Thus the large bank holdings of government securities, far from adding to the interest burden, have served enormously to lighten the burden. It has done so, not only by adding directly (through bank purchases) to the demand for securities, but also by increasing the cash holdings of the public. Commercial bank purchases of securities (by reason of the power to create new money) at one stroke increases both the *demand* for bonds and also the *supply of funds* seeking investment.

Demand for Government Securities.

According to the President's Budget Message, the Treasury, by drawing down its large cash balances, will reduce the public debt slightly during the fiscal year ending June 30, 1947. Thus the supply of new issues will dry up. The purchase of savings bonds may exceed the redemptions, and financial institutions will continue to invest in government securities. This may involve some retirement of other kinds of government obligations. A strong demand for government securities is thus not unlikely.

This would be accentuated if the banks continue as they have tended to do in the past, to shift from short-term securities to long-terms, thereby increasing their earnings. If this were allowed to develop on a large scale the effect would be (1) conversion of the public debt in larger volume into medium- and long-term issues, (2) lower interest rates on long-terms.

During the war the Federal Reserve System adopted the policy of maintaining a wide spread between short-terms and long-terms. To maintain this structure the Federal Reserve Banks were compelled to purchase all offerings of short-terms by banks. This enabled the banks to replenish their reserves at any time by selling short-terms. On the basis of this increase in reserves, they could then on a multiple basis enormously expand their holdings of long-terms.

The Interest Rate Structure.

There are various ways in which this problem could be managed: (1) increasing differentiation of government securities available for bank investment on the one side, and for the public on the other, (2) raising the rate on short-term securities, (3) requiring the banks to hold a reserve of government securities of a specified type against their deposit obligations in addition to the current cash reserve, and (4) permitting the commercial banks to hold only a limited proportion of their assets in long-terms.

Already a number of the long-term securities issued during the war are not available for bank investment. It would be possible to exclude banks altogether from long-term securities extending beyond a given maturity. This would prevent banks from reaching further and further out into long-terms, would

tend to hold bank earnings from government securities within reasonable limits, and would safeguard the investing public from a continually falling and perhaps unnecessarily low rate of interest. A low rate of interest is indeed desirable but it may be pushed too low. As Sir John Anderson has so well said, "It is well to move gradually and to avoid sensational changes in a factor so interwoven as is the rate of interest with our social as well as our economic fabric." [19]

Already we have gone a considerable distance in differentiating the public debt from the standpoint of different classes of investors. There are the special issues for the government trust funds, there are the war-savings bonds with favorable interest rates (and limited purchase privilege for large investors) and there are nonmarketable Treasury tax and savings notes Within limits, special issues for separate classes of investors can serve a useful purpose. Carried too far it would so compartmentalize the debt that the structure of interest rates would no longer be subject to market forces. Wide freedom of choice for investors on balance promotes a well-functioning money and capital market.

Bank Holdings of Short-terms.

Working at the problem from the other end, what can be done to promote bank holdings of short-term securities? The rate of interest on 3-month Treasury bills and 9- to 12-month certificates of indebtedness could be raised. This would indeed tend to keep banks out of long-terms, but would swell bank earnings unduly and raise the interest charges on the public debt. The policy, however, recommends itself from the practical standpoint in the respect that it requires no new legislation and is less novel and controversial than some other proposals. Moreover, the problem of bank earnings could be managed either by a special tax on deposits or by an excess-profits tax on banks.

Approaching the problem again from the angle of keeping the banks in the short-terms, we come to our third method outlined above—a "security reserve" against deposits. Hitherto a cash reserve has been required, the reserve ratio being subject to variation within limits imposed by the Board of Governors. In addition to the required cash reserve, a security reserve could be im-

[19] House of Commons, Apr. 24, 1945.

posed by law, possibly again within limits set by the Board. Such a regulation might require banks to hold short-term securities up to, say, 40 to 50 per cent of their deposit liabilities. Banks might be allowed (on top of the "cash-reserve" ratio) to substitute cash for short-term securities in meeting the security-reserve requirement. In other words, the required security reserve could consist of cash or short-term securities in any proportion desired by each bank.

The advantages of this procedure are as follows: It would provide an assured market for short-term government securities, while retaining the advantage of a wide spread between short-term and long-term interest rates. A check would be imposed upon excessive bank earnings, while public investors would be safeguarded from undue bank competition in the long-term investment market.

An alternative procedure would be to require banks to hold a special issue exclusively available for banks to satisfy the security reserve requirement. Such special issue would carry a low rate of interest.[20] The effect of this procedure would be to keep banks in large measure out of long-terms, while at the same time permitting such investments insofar as the requirements of the security reserve and their resources permit.

The fourth method, to limit the proportion of banks' assets which may be invested in medium- or long-term government securities, is along the lines of the recent voluntary agreement reached in Canada between the Bank of Canada and the commercial banks.

Debt-management Goals.

Broadly, the aims of debt management, from the standpoint of monetary policy, should be (1) to supply a wide variety of securities designed to satisfy the requirements of all kinds of investors, (2) to keep the long-term rate of interest low and stable, (3) to prevent excessive interest payments to banks, (4) to provide a favorable savings-bond rate of interest for small investors, (5) to ensure a volume of liquid assets (cash and securities) for business and

[20] This rate might be subject to adjustment by joint action of the Board of Governors and the Secretary of the Treasury, according to changing circumstances relating to interest rates and bank earnings.

individuals designed to promote a flow of investment and consumption outlays adequate to provide full employment, but not in excess of the requirements of stability.

The job is no easy one. It cannot be achieved by simple rules that are supposed to operate without the intervention of informed judgment. It is a continuing task. It requires flexible adjustment to changing conditions. The modern economy will just not run itself. But the task is a manageable one.

Appendix A

Hayek's "Road to Serfdom"[1]

A NEW book by Friedrich A. Hayek,[2] *The Road to Serfdom*, has been making a remarkable stir of late. Visitors from Great Britain report that it has sold in volume there and is one of the most discussed nonfiction works since the war began. In the United States also it has sold very widely, and within a few months after publication has run into several printings. It achieved the remarkable distinction of the leading review on the same day in the Sunday editions of *The New York Times* and *The Herald Tribune*. It had the honor of an extended discussion in *Fortune*. Such a volume deserves attention regardless of its intrinsic merits.

It is the thesis of Hayek's book that "the rise of fascism and Nazism was not a reaction against the socialist trends of the preceding period but a necessary outcome of these tendencies." There are a large number of "points where at an interval of fifteen to twenty-five years we seem to follow the example of Germany." In like manner, "in more recent years Sweden has been the model country to which progressive eyes were directed." It is necessary "to state the unpalatable truth that it is a Germany whose fate we are in some danger of repeating." There are "symptoms of a definite trend" that suggest that "developments will take a similar course" and are "moving in the same direction" (pp. 2-4).

The road that we are traveling, which Hayek believes will likely lead us to Nazism and Fascism, is again and again throughout the book described as "socialism" and "planning"—the two terms being regarded as synonymous. About what is to be included under the umbrella of these terms we shall have more to say later. But these terms describe, Hayek believes, the road we are on now,

[1] *The New Republic*, January 1, 1945.

[2] Friedrich A. Hayek, *The Road to Serfdom*, University of Chicago Press, Chicago.

and indeed the one we have increasingly been traveling during the last 75 years. We have witnessed a "complete reversal" of the older liberal trend, "an entire abandonment of the individualist tradition which has created Western civilization." The reign of these ideas had reached its widest expansion by "about 1870." From then onward it began to retreat (pp. 20-21; 32-35).[3]

Hayek fears that we do not want "to understand the development which has produced totalitarianism because such an understanding might destroy some of the dearest illusions to which we are determined to cling." We need to examine the "character and the growth" of these ideas. If we "take the people whose views influence developments, they are now in the democracies in some measure all socialists. If it is no longer fashionable to emphasize that 'we are all socialists now,' this is so merely because the fact is too obvious" (pp. 4-6).

Now what are the institutions we have been building increasingly during the last 75 years—the road to Nazism and Fascism? They are very meagerly described by Hayek. And it is not difficult to detect that the moment he becomes concrete and specific he finds his task pretty difficult. The going is easy wherever the argument proceeds under the banner of "planning" and "socialism." These are very convenient words. Are we sure we know what they mean? Hayek indeed concedes that the terms "capitalism" and "socialism" conceal rather than elucidate the nature of the transition through which we are passing. But he continues, nevertheless, to use "socialism" throughout the book. And by "socialism" he means "planning."

But "planning" is a rather troublesome word. Hayek finds that there is good planning and there is bad planning (p. 42). That looks like a good start. The lad in Sunday school is told that there is good and evil in the world—good boys and bad boys. He resolves to trail only with the good boys. But who are they? The Sunday-

[3] Incidentally, it is not without interest to note that just at this point around the 1870's, when the individualistic tradition had reached its height, government in the United States, both federal and local, hit an all-time low. Government is still very far from perfect in the United States, but at any rate it is not where it was then. The peak of laissez-faire capitalism did not seem to produce good government. This area deserves more study, particularly in view of Hayek's allegation of a high correlation between individualism and democracy.

school teacher does not have to face such concrete questions. That is a job for the Boy Scout leader. With his intimate knowledge of the "gang," however, the scoutmaster knows that he would have to be very arbitrary indeed if he were called upon to make a clean separation of the "sheep" from the "goats." Can you think of any piece of legislation that is 100 per cent good? I can't. I have often thought that no matter how one shapes it up, it is wrong. Alexander Hamilton very wisely said: "It interests the public councils to estimate every object as it truly is; to appreciate how far the good in any measure is compensated by the ill, or the ill by the good: either of them is seldom unmixed." Not so for Hayek. For him the world is a very simple affair. There is good planning and there is bad planning.

Now what is "good planning" according to Hayek? Again the definition, abstractly considered, is easy. It is "planning for competition." And bad planning is "planning against competition."

Among the institutions and programs increasingly adopted by modern democracies are labor legislation with respect to maximum hours and minimum wages; legislation legalizing collective bargaining; social-security legislation, including unemployment insurance, health insurance, and old-age insurance. All of these have certainly been called "socialism" time and again. Are they good or bad planning? Are they planning for or against competition?

I find it very difficult to see how these measures can be described as "planning *for* competition." It is generally believed that collective bargaining, minimum-wage boards, and unemployment insurance limited competition in the wage market so as to cause the "rigidity of wages" experienced in Britain during the price deflation following the return to the gold standard. Nevertheless, Hayek favors a "comprehensive system of social insurance." As all modern readers understand that term, it certainly includes unemployment insurance. But what now becomes of his criterion about good and bad planning? As soon as one becomes a Boy Scout leader and faces reality, one is in trouble.

Mr. Chamberlain implies in his foreword that Hayek favors "minimum-wage standards." I have not been able to verify this in the book, though by inference what is said on page 120 might be so interpreted. I do find specific approval of maximum hours

(p. 37). Hayek is almost completely silent, so far as I can discover, about labor unions. He speaks critically of "joint monopolist action of capitalists and workers in the best organized industries." Is he against unionism and collective bargaining? Surely collective bargaining is one of the most crucial of all the institutions of modern democracies. Must we turn our backs on it, or can we include it under "good planning"? But Hayek prefers not to become a Boy Scout master. The "ivory tower," where hard decisions do not have to be faced, is more comfortable.

With respect to social security, the matter is even more nebulous. Here Hayek says he is for a "comprehensive system of social insurance" (p. 121). But he adds: "The planning for security which has such an insidious effect on liberty is that for security of a different kind. It is planning designed to protect individuals or groups against diminutions of their incomes, which although in no way deserved yet in a competitive society occur daily, against losses imposing severe hardships having no moral justification yet inseparable from the competitive system" (p. 122). Now what can we make out of that? Is he for the Beveridge program or against it? That is the kind of tough question we have to decide in our modern democracy. The best I can make out of it is that Hayek favors the measure of social security that England has now, since (p. 120) he seems to speak approvingly of the sort of security that has long been achieved. Yet this is one of the most important sections of the "road we have been traveling." We are therefore left in confusion. I suspect he is against Beveridge. And I think I know his past ideas well enough to be fairly sure that he was against all social security, as well as labor unions, before he came to England. There are many signs in this book that he has become "corrupted" during his stay in England by "modern ideas."

As is well known, British social policy and institutions are not very logical. Things that "don't mix," that don't fit into such neat patterns as "planning for competition" and "planning against," exist side by side. But somehow this clumsy organism lives on. And can one seriously deny that life in England is more wholesome today and more democratic than ever before in English history?

There are other concrete policy questions about which Hayek remains discreetly vague. Mr. Chamberlain tells us that he is for

"certain types of government investment" (p. vi). Hayek cites (p. 39) Adam Smith's approval of governmental undertakings which "though they may be in the highest degree advantageous to a great society, are, however, of such a nature that the profit could never repay the expense to any individual or small number of individuals." These tasks, says Hayek, provide "a wide and unquestioned field for state activity." The word "unquestioned" encourages us to hope that here at last we shall have no doubts. Does this mean that Hayek favors the TVA, the redevelopment of urban slums, low-cost public housing? I can't answer, though he is explicitly (p. 227) against a TVA in the Danube Basin. These questions are hard upon us in the United States. Are these things "good planning" or "bad planning"? If we do these things, will they lead us further on the road to serfdom? [4]

Hayek favors antidepression monetary policy, but he does not tell us of what it should consist. Presumably it is not the monetary policy he advocated 15 years ago, now thoroughly discredited, and even abandoned by Hayek himself in favor of the highly dubious "commodity reserve currency." As to fiscal policy (pp. 121-122), he favors a very small dose, but refrains from telling us whether the British White Paper on Employment Policy is good or bad planning Will it also lead us down the road to serfdom? Again Hayek prefers not to become a scoutmaster. At this point it would have been a useful service if Hayek had stressed more than he does the difference between *direct* and *indirect* controls. Monetary and fiscal policy do *not* regiment the market.

I have noted above that Hayek is incredibly skimpy about the nature and character of this "road to serfdom" which all modern democracies are on. It is therefore of interest to note that a large part of such concrete analysis as he does give relates to tariff protection and to various forms of monopoly, including cartels, combines, and big business with "one or at most a few giant firms." These are clearly forms of "planning against competition." American businessmen will be interested to learn that such "planning"

[4] Even education, which Hayek unreservedly supports as a state function, presents problems. In the United States, many poor states do not have the fiscal capacity to furnish a minimum standard education for their children. Federal aid on a large scale is necessary. But here we encounter the fear of centralization, about which Hayek is also concerned.

is also "socialism," these terms being synonymous. Thus we may infer that Alexander Hamilton, who introduced our protective-tariff system, was our first socialist starting us down the road to serfdom. Hayek, I hasten to add, does not cite Hamilton, but he does cite Bismarck's adoption of protectionism in 1879 as an early milepost down the road to Nazism (p. 175). Fichte, Rodbertus, Lassalle, and Hegel in Germany and Thomas Carlyle in England and Auguste Comte in France all nurtured the roots of Nazism (Chap. XII).

This kind of writing is not scholarship. It is seeing hobgoblins under every bed.

Let the reader set down any proposition about historical development he may choose. By diligently applying Hayek's methods he will find no difficulty in neatly proving his thesis.

The "monopolistic organizations of industry" is the "tendency which is the great immediate danger" (p. 194). This "movement is, of course, deliberately planned mainly by the capitalist organizers of monopolies." Nevertheless, it would be a "mistake to put the blame for the movement exclusively or mainly on that class," for they have "succeeded in enlisting the support of an ever increasing number of other groups" (pp. 184-186).

As my readers well know, I am no friend either of high tariffs or of monopoly in its various forms. But no good comes from exaggeration. We have a long history of both tariffs and monopoly in the United States, and they confront us now, as formerly, with serious problems for our democracy. I welcome any aid that Hayek can offer in the fight. I doubt that it will help matters to get hysterical about these agelong problems, or to subsume these manifestations of "planning against competition" under the title of "socialism." And I especially regret that Hayek has seen fit in a footnote (p. 203) to argue that the suppression of useful patents is "so exceptional that it is doubtful whether this has happened in any important instance." On this point Corwin Edwards may, I think, be entitled to a respectful hearing as a competent witness. Free enterprise, it seems to me, would be fostered by making available all inventions and new processes to any user upon payment of a reasonable royalty. The Alien Property Custodian has laid down the rule that no patent in its possession shall become the *exclusive* possession of any firm. But one gets no sup-

port from Hayek here. Nor does he have anything to say about the stimulus to new enterprise and to smaller competitors which large-scale governmental research (the findings of which should be made freely available to all business) could offer.

But let us get back to the main argument. All present-day democratic countries have for many decades past had much in common with Germany before the advent of Hitler. All were becoming more urbanized and industrialized. Social-welfare expenditures were increasing. Social-security measures, collective bargaining, and labor legislation were everywhere adopted. Consumers' and producers' organizations were growing. Educational facilities were rapidly expanding and workers and farmers were more and more exerting a political influence. Governmental expenditures in relation to national income were everywhere growing. Business units were becoming larger and larger, and an ever-growing proportion of wage earners were employed by large concerns. Tariffs and other restraints on trade were everywhere on the increase, especially after World War I. Agricultural subsidies and adjustment programs, together with commodity agreements, interfered with the free market. This catalogue by no means completes the picture, but the reader can easily fill in the gaps.

The point is that the democracies and Germany had very much in common. Therefore, according to Hayek, since Germany went Nazi, it is highly probable that all the rest will go the same way in due time. All have been traveling the same road—the "fifty years' approach toward collectivism" (p. 211).

Since Germany is the only "black sheep" in the family of Western democracies (Italy and Russia obviously don't belong here), would it not be more sensible to inquire into the special conditions that might explain the rise of Nazism? I do not pretend that this is an easy task. But Hayek has not even attempted it. Since one member of the family with a common environment went wrong, he concludes, they all are going that way. One might have expected that a case study would be in order.

Hayek barely mentions the defeat and "the war hysteria of 1914, which, just because of the German defeat, was never fully cured" (p. 169). The astronomical inflation and its effect on the middle class is not considered. The Junker military tradition is brushed aside as of no consequence. Nor does he examine the ab-

sence in Germany of deep democratic traditions such as had grown up over the centuries with deep roots long before the age of modern capitalism in Anglo-Saxon countries. It is not without significance that the intellectual classes in Germany before 1914, and even in the Weimar Republic, prided themselves on not stooping to interest themselves in mere "politics."

The Western democracies—at any rate England, the Scandinavian countries, Holland, the British dominions, and the United States—will have none of totalitarianism. But they do believe in a "mixed society." Hayek asserts (p. 42) that such a society will not work. But the fact is that it is working in a manner to produce not only the highest standard of living ever achieved, but also wider participation by the masses of the people in their economic and political affairs. Sweden, the country that Hayek cites (p. 3) as far along the road to serfdom, is a "mixed society." Private enterprise, state enterprise, and cooperative enterprise flourish and prosper side by side. And through trade unions and collective bargaining, through cooperatives, and through the eager and intelligent participation in politics and the active management and control of the state for the common good, the people as a whole have achieved as never before a high degree of personal liberty and freedom. The picture is more or less the same in all the Western democracies. And as for the United States, Hayek should come and visit us during a presidential campaign. He would not learn anything that would improve his excellent literary qualities, but he would learn what a free press and free speech mean. He would learn that Americans have a fierce love of liberty and they know how to put in his place any government official or bureaucrat who tampers with their liberties. This is something that the German people at no time in their history knew how to do.

I have omitted consideration of Russia and Italy. Russia clearly reached totalitarianism and communism not by way of the road that the Western democracies are traveling, but via czarism. This fact is slurred over by Hayek and he only calls attention to the totalitarian and regimental similarities between Russian communism and Nazism. As for Italy, it is clear that she could hardly be classed with the Western democracies in view of her general backwardness in terms of almost all the essential characteristics of the advanced countries. The plain fact is that Italy, Russia, Japan (not

mentioned by Hayek), and Germany all reached totalitarianism by very considerably divergent roads.

Hayek's book will not be long lived. There is no substance in it to make it live. But it will momentarily stir up a good deal of discussion, and this is all to the good. It is no new thought to Americans that eternal vigilance is the price of liberty. We need now as always to be on guard. We face serious dangers ahead. We always have and we always shall. And as a goad to fresh self-examination it may well be that Hayek's *Road to Serfdom* is, as has been suggested, "good medicine but a bad diet."

Appendix B

Some Notes on Terborgh's "The Bogey of Economic Maturity"[1]

THE notion seems to run through Terborgh's book (and indeed in part through Wright's review[1]) that the "mature economy"[2] thesis holds that economic stagnation is unavoidable. In fact, the bulk of my writing has been devoted to an analysis of economic policies that would give us an expanding economy and full employment. The question really is: Would a policy of mid-nineteenth-century *laissez faire* give us that degree of expansion and full employment which we experienced in that century?

The essential issue is: Are the automatic forces making for investment outlets as strong in our world today as in the century preceding World War I? It has always been recognized, from the classicals on, that the leading factors underlying investment opportunities are (1) the discovery and development of new territory and new resources, (2) population growth, and (3) inventions. In the century preceding World War I the existence of a vast unexploited continent with rich natural resources, together with the phenomenal growth of population, everywhere gave rise to optimistic expectations with respect to investment. Invention, new products, and new industries were equally important. Undeveloped resources and population growth may be described as *extensive* expansionist factors, while invention may be termed an *intensive* expansionist factor. No one denies that the extensive factors play in the current world a relatively smaller role. The argument

[1] See *Review of Economic Statistics*, February, 1946.

[2] The term "secular stagnation," it should be noted, is not applicable alone to mature economies. It is perhaps the best English rendition of Spiethoff's phrase "Stockungsspanne." Even in the nineteenth century we had prolonged periods of stagnation in which there was a preponderance of hard times, recovery and prosperity being short-lived and depressions long and severe. (See *Fiscal Policy and Business Cycles*, Chap. I)

of the critics seems to be: Well, why worry?—The intensive factors are still present. If one member of a team drops out, the other can pull the full load. This may indeed be so, but at least the probabilities are the other way.

I do not think that anyone will deny that if we should wake up tomorrow and find that a vast new rich continent had suddenly emerged in the Pacific or in the Atlantic, equal in resources to the North American continent, the investment opportunities for private capital in the next few decades would be enormously improved.

With respect to population growth, let anyone consider (as Geoffrey Crowther did in a recent article in *Foreign Affairs*) the probable volume of capital formation in the United States in the year 2000 compared with that in Great Britain. In making such an estimate, one would surely want to take cognizance of the larger probable growth of population in this country. That capital formation is related to volume of output is, so far as I know, not questioned. Nor is it questioned that increase in volume of output is related to (1) growth of labor force and (2) increase in per capita productivity.

The relation of capital formation (investment outlets) to population growth is now, it should be stressed, fully recognized by Terborgh in his new book. He argues that population growth has accounted for about one-third of *gross* capital formation. This figure is in fact somewhat higher than my 50 to 60 per cent of *net* capital formation.[3]

While admitting the major role of population growth in capital formation, Terborgh wonders why the declining percentage increase in population did not reveal itself in an unfavorable manner until recently. The fact is that the percentage decline in population in the United States was not marked until after World War I. Thus in the decade 1860-1870 the percentage rate of in-

[3] Terborgh is in doubt whether I meant "gross" or "net," though the context and the language used by me should have made that quite clear. No one else as far as I know has assumed that I meant "gross." I do use the term "total new investment," but I am not aware that the word "total" has ever meant "gross." I used "total" because I was analyzing two component parts of net investment: (1) that related to population growth and the development of new territory and (2) that related to invention and technological progress.

crease was 2.7 per cent per annum; from 1870-1880, 2.6 per cent; while in the decade 1900-1910 the rate of increase was 2.1 per cent per annum—a relatively small decline. After World War I, however, the percentage rate of increase was markedly lower and fell to 0.7 per cent in the decade 1930-1940. If we assume roughly that the per capita increase in productivity was 1.5 per cent per annum, we may then say that in the seventies the total rate of growth (labor and productivity) was 4.1 per cent per annum, while in the decade before World War I it was 3.6 per cent per annum. The difference is obviously not great. Thus it is, I think, appropriate to consider World War I as a turning point. That the decade of the twenties was nonetheless a decade of expansion and prosperity is not difficult to understand in view of the repercussions of World War I upon capital formation resulting from the accumulated shortages caused by the war, plus the unusually favorable accidental factor of the development of giant new industries related to the automobile and electricity. Moreover, the *absolute* rate of population growth was at a peak in the twenties, equaling that of the great decade of expansion before World War I.

Apart from the long-run (secular trend) effect of population growth (percentage rate) upon capital formation, one must also consider the absolute *increments* of growth. The business depression beginning in 1929 was the first one in our history in which a drastic decline in the absolute increment of population growth occurred. Now we all know that the acceleration principle in business-cycle theory is based on the absolute increment of growth of final demand and not on percentage increase.[4] Here was a wholly new factor that contributed to the severity of this depression. In previous depressions business had always been buoyed up by the expectation of continued increases in the increments of population growth. If overexpansion had occurred, it was soon made good by reason of the large absolute rate of growth.

[4] In my address as President of the American Economic Association I analyzed population growth in terms of long-run factors making for capital formation, and this related largely to percentage rate of increase. In my T.N.E.C. testimony, however, I made special application of the acceleration principle to the depression beginning in 1929 in terms of the absolute increment of population growth

There is validity to the point that for some problems *families* are relevant rather than *population*. But this is not true for all problems. With respect to housing, for example, it is well known that the tendency toward small families is one of the important factors that has caused the trend toward smaller houses. With respect to investment, it is not the number of houses but the amount invested that is significant. Even so, the absolute increment of growth of families also declined for the first time in the decade of the thirties

Terborgh has much to say about the fact that prior to World War I the differential percentage rate of population growth in different countries does not seem to have influenced the per capita increase in real income. This is true, but it proves nothing. Terborgh agrees that population growth is a major factor influencing capital formation. How, then, did France with a stationary population fare so well? In general we know that prior to World War I, France invested about half of her net savings abroad; Germany, with a rapid growth of population, found outlets for substantially all her net savings at home; while England was intermediate with respect to both population growth and the proportion of net savings invested at home. In spite of small investment outlets at home, France, in the highly international economy existing prior to World War I, was able quite easily to invest half of her net savings (small, in terms of the total world economy) abroad. Her internal investment, while small, was nevertheless adequate in view of the stationary population to permit taking advantage of inventions and improving technology and thus raise the per capita real income at the normal world rate. The really interesting thing about all this is that the investment outlets in France were small compared to those in Germany and that a large proportion of her net savings had to be invested abroad in order to maintain internal prosperity and employment. This was not difficult for a relatively small economy like that of France. But no one, I think, is likely to suppose that it would be easy for an economy so large as that of the United States to find investment outlets abroad for half her net savings. Terborgh's analysis fails to get at the really root issues involved.

I commend Chap. V to the careful consideration of statisticians. It is an amazing chapter. Elaborate statistics are assembled to show

that the capital formation in the pioneer states of the West is lower per capita than in the old settled states of the East. There are some things on which there is no need to waste research funds. No one will dispute the conclusion reached, but what of it? Terborgh argues that, since this is so, we should have had more capital formation had there been no West and had the population all grown up in the East! (The first question, of course, is, Would our population and therefore capital formation have been the same had there been no West? And the second question is, Did the opening of the West have no influence on capital formation in the East?) Terborgh, after having developed this conclusion, takes a second look at it and sees quite clearly that there is something wrong. He finally concludes that, after all, what he had said wasn't quite right and that in fact we *are* richer and have more capital formation East *and* West because of the great West and its development. What, then, is the purpose of the chapter? This apparently did puzzle him, as it certainly did me, and so he finally concludes that, while the development and settlement of the West did result in more capital formation, nevertheless, this has nothing to do with the "frontier theory." He then says: "We are richer not because we started on the Eastern seaboard and worked our way West," from which one must infer that his opponents had argued that the peculiar merit of the West was that *we moved west,* and that the effect would not have been equally favorable had we started on the Pacific Coast and moved east!

With respect to the "afterglow"—and indeed the whole argument in this chapter—Terborgh seems to miss the very elementary point that the development of the great West did not result merely in capital formation in the Western states, but was in large measure responsible for the vast capital formation in the settled East and the larger centers. For a simple (though itself relatively unimportant) illustration of this important factor, one may cite the giant office buildings of our great national companies, doing a nation-wide business but located in New York City. The investment in the older settled centers was in very large measure the result of the development of the entire continent.

Terborgh has much to say about the American frontier ending in 1890. The term "frontier," while at times useful, is far too narrow and limited in scope. My own discussion has run mainly

in terms of the economic development of new territory and new resources. Nevertheless, with respect to the frontier, the economic *development* of the last frontier states had scarcely started by 1890. It is true that the political historians have used 1890 as the date for the closing of the frontier, and this is correct in the sense that free homesteads after that date were no longer available, but the *economic development* of the last frontier had a full generation to go after 1890. The land had to be broken, buildings had to be erected, railroads built, warehouses, commercial establishments, and houses constructed. The frontier in terms of frontier *development* lasted on until World War I. It is wholly incorrect to say that the economic frontier ended in 1890.

With respect to the impact of new industries upon capital formation, I am quite content with Terborgh's figures. Fifteen per cent, or thereabouts, of gross capital formation (30 per cent of net) is ample to make the difference between depression and prosperity. In minimizing the place of new industries in gross capital formation Terborgh forgets the leverage effect of the multiplier and the acceleration principle.

Terborgh thinks that the high ratio in mature economies of replacement investment to gross capital formation is not of great significance. With this I cannot agree. Consider the decade of the thirties—1931-1940. In this decade producers' gross capital formation amounted to about 60 billion dollars, of which only 5 billion was "net." That 60 billion dollars, however, quite obviously was sufficient to equip our plant and equipment with highly modern techniques. Our productive capacity increased enormously in this decade, else how could we have produced the output of 1941 and 1942, which was achieved on the basis of the productive facilities built in this decade? To be sure, as we got into the war, government war plants were coming in, but this was of no major importance until 1943. It is an impressive fact that the modernization of plant and equipment in the decade 1931-1940 offered hardly any outlet for net savings.

I have, of course, never argued that replacement expenditures are *automatically* provided for in replacement savings. I have argued, however, that the rise of the corporation, together with better accounting procedures for both corporations and unincorporated businesses, has resulted in more adequate provision, than

under more primitive conditions, for systematic replacement savings. This would tend to raise the savings function.

Terborgh admits that decline in population growth does reduce investment outlets, but he argues that on the other side a more slowly growing population, with a larger proportion of people over the age of sixty-five, tends to save less. Clearly the age distribution of the population is a factor that must be considered as very probably influencing the consumption and savings functions. But Terborgh has completely forgotten that in a stationary population not only is there a high proportion of old people (spenders) but also a very low proportion of children (upon which parents are compelled to spend). Roughly, the percentage of population in the middle age group is about the same in a stationary population as in a growing one. Thus as a first approximation one could argue that the age distribution of a stationary population is not likely to change the savings function as compared with the age distribution of a growing population. While the small proportion of children tends to raise the savings function, on the other side, the high proportion of aged people tends to lower it. In the great *transition,* however, from a rapidly growing population to a stationary population (which we are now experiencing), the proportion of children (owing to the extraordinarily rapid decline of the birth rate) is small, while we have not yet reached the point where the proportion of aged is very large. Thus we have recently been passing through a phase in which the age distribution clearly tends to raise the savings function, and this has intensified the savings-investment problem. These matters Terborgh has entirely overlooked.

There is much more agreement between Terborgh and his opponents at many points than appears evident from his book. Thus he has much to say about the building cycle and its influence on the thirties. This I have myself fully elaborated in my *Fiscal Policy and Business Cycles.* While I have indeed attempted to appraise the impact of population growth, new territory, and new industries upon investment, I have set these against the background of other factors, at times far more important, including the 40-month cycle, the major cycle, advances in technology, the building cycle, and many other factors including institutional adaptations to change. At times Terborgh even flatly asserts that

his opponents have "overlooked" certain factors which, in fact, have been elaborated again and again. Consider, for example, his discussion of the secular rise of the consumption function and in this connection see page 233 of my *Fiscal Policy and Business Cycles* as well as Samuelson's chapter in Harris's *Postwar Economic Problems.* Consider also his discussion of the violent fluctuation of business profits and in this connection read my Chap. 11, page 244, in *Fiscal Policy and Business Cycles.* It is encouraging to find Terborgh (pages 202 and 206) arguing approvingly that social security and progressive taxation tend to raise the consumption function, but it is rather shocking to have him say that these matters seem to have been "overlooked by the proponents" of the mature-economy thesis.

It is very interesting to find that Terborgh finally not only admits that the decline in population growth does tend to reduce investment opportunities but also that institutional reforms including social security and progressive taxation may in part offset this unfavorable factor by raising the propensity to consume. This agrees precisely with my own analysis. To repeat, I have never argued that we could not successfully adapt ourselves to changing conditions and thereby ensure an expanding and a prosperous economy. Moreover, I welcome his support of a compensatory fiscal program, but regret that he did not equally support an expansionist development program such as TVA, MVA, urban redevolpment, and the like.

The three programs which I have mainly relied upon as reasonable adaptations to our changing economic condition are: (1) social security and progressive taxation, (2) compensatory fiscal policy, and (3) a developmental program. Terborgh supports the first two. In this connection it is of interest to note that it is precisely the social security and the compensatory policy which are modern programs, while long-range developmental programs of public investment have been used throughout our history beginning with Alexander Hamilton, Gallatin and his system of public roads, canal building, and the vast government support to the building of railroads. While Terborgh has much to say about artificial government "crutches," he himself, I am glad to note, is not adverse to making sensible adjustments to a changing world in our social institutions. I am convinced that the time is rapidly

coming when the continuous use of a compensatory fiscal program will be regarded by businessmen and the public alike as the most natural thing in the world—a thing to be taken for granted in a well-run society.

In conclusion I may briefly state my own position. It seems to me evident that the automatic factors inducing private investment outlets are not so strong as in the great days of expansion prior to World War I. We now need to develop a new frontier, so to speak, in our own back yard and thereby open new outlets for private investment. There is plenty to be done. Look at the condition of all our great metropolitan communities—rotting at the centers with ever-spreading blight. Here is a rich field for development and investment, public and private, but there are few, if any, of those familiar with the problem who believe that it can be done without the government's playing a vigorous role. We need in our day peculiarly to be ingenious about finding new outlets for investment and expansion. In the old days, with vast, rich resources untapped, it was a simple matter. For us we need ingenuity, courage, teamwork, and cooperation between government and industry.

As I have worked in recent years on regional resource development, urban redevelopment, education, public health facilities, and the like, I am impressed with the futility of much of the current discussion. When a compensatory and development program is advanced, the argument is not infrequently made that "this is all good and well, but there are no useful outlets for government outlays." On the other side, the practical people, painfully aware in their everyday contacts of the urgent needs, are always wondering where the money is coming from. I am convinced that economists have been grossly negligent as a profession in failing to examine the grave deficiencies in our society. Many of these cannot be overcome except by public investment in our material and human resources.

Appendix C

Sixty Million Jobs[1]

HENRY WALLACE'S *Sixty Million Jobs*[2] contains an immense amount of accurate and highly significant information. It is packed with facts. To read it is an education in applied economics. It should be read and reread by every voter.

Wallace is well known for packing his speeches and his writings with statistics. But this is not a book of dry statistics. In every section there is clear analysis which any intelligent reader can follow. No one who reads it discerningly can say that Wallace is interested merely in jobs. Jobs are the means to the "good life" for the individual, the family, and the nation. The enduring values, amid the survey of markets, production, jobs, finance, and technology, are never forgotten: the concluding section is entitled "The Fuller Life for All." "In the final analysis the full life is a thing of the spirit. It is a matter of ideas and ideals, of both education and religion."

The book contains a few well-selected charts and tables which ought to become a part of the mental furniture of every American citizen. One relates to the rising trend of the national product from 1880 to 1944. Another shows the distribution of 47 million jobs in 1940 and the projected 60 million jobs in 1950. The table on "National Budgets for 60 Million Jobs" is a model of clarity, simplicity, and effectiveness in the exposition of a difficult idea. Every citizen would be a more enlightened member of our democracy if he undertook to master the few highly significant charts and tables in this book.

Sixty million jobs, a 200-billion-dollar Gross National Product, being round numbers, make convenient slogans. But it happens that these round numbers are thoroughly defensible and indeed represent the consensus of competent statistical opinion. It must

[1] *The New Republic,* Sept. 17, 1945.
[2] Henry Wallace, *Sixty Million Jobs,* Simon and Schuster, Inc., New York.

be emphasized, however, that these figures relate to the year 1950 and to the 1944 general average index of prices.[3] A full-employment national product, say in 1946, would be substantially lower· first, because the labor force would be nearly 2½ million lower than in 1950 and, second, because we may reasonably expect a considerable increase in per-worker productivity from 1946 to 1950. Thus a 200-billion-dollar Gross National Product for 1950 at full employment would be equivalent to, say, a 180-billion-dollar Gross National Product in 1946. And if one prefers to make his estimates in terms of 1942 prices, it would be necessary to knock off another 10 billion dollars—thus giving 170 billion dollars as the full-employment Gross National Product for 1946. Many of my readers, I am sure, have become familiar with the much-quoted 170-billion-dollar figure, and I cite the data just given to show that it is not inconsistent with Wallace's goal.

The basic importance of a full-employment program is pointed up in the chapter on the "Interdependence of the Parts." Specific programs dealing with specific problems can have only a limited success unless the general over-all goal of full employment is reached. Thus, for example: "Fifteen million postwar unemployed would mean a cut in net agricultural income to about one-fourth of what it was in 1944." Again:

"The GI Bill of Rights doesn't mean much unless there is full employment for all. If there is not full employment, most of the veterans who borrow money to go into business will lose it; many of those who borrow money to buy farms will lose their farms; those who use the government to pay for their education may find it impossible to find a place for their specialized skill when they finish school. By all of which I mean to say that, fundamentally, the only real way to protect the veteran is to produce to the limit for prosperous peace."

Wallace, like Hamilton, Gallatin, Henry Clay, and John Quincy Adams before him, believes that "our democratic government has the definite responsibility of stimulating our free-enterprise sys-

[3] Shifts of course will occur in the price level of different commodity groups. Farm commodity prices will certainly be lower, relative to industrial prices. Furthermore, it must be emphasized that the use of a general level of prices as a means of statistical measurement of gross national product should not be taken as a forecast.

tem, not just in behalf of the general welfare, but also to keep free enterprise continuously a growing concern." The author calls to witness the role of internal improvements, the Homestead Act, the subsidizing of the railroads, the "expansion of the automobile industry by building more and better roads," the aid to our shipping and aviation industries. "Largely because of this governmental stimulation and participation, we have never failed, even in the last three generations, to double our national production every twenty years. . . . The future is filled with new frontiers."

In order to keep free enterprise free and to keep the door open for new industry, Wallace stresses the importance of research. Fundamentally, the most significant things in a modern economy are "ideas, technology and natural resources." We must have "technological freedom as well as political freedom." In the world of tomorrow we shall have to be "constantly alert if we are to hold our own in science and technology":

"But free enterprise will be shackled and restrained if research is dominated by a small number of corporations and cartels. . . . Unless the little man also has access to the bounties of technology, free enterprise will suffer to the detriment of the full employment of labor and our resources. . . . Most of our advanced research is concentrated today in about one hundred companies; and this concentration inevitably results in the restricted use of scientific information."

Wallace believes that the federal government should make research facilities available to the thousands of small businesses. As Secretary of Commerce, he can be expected to lay out a program of conducting, sponsoring, and coordinating research for industry in general and small business in particular, such as the Department of Agriculture has for many decades past performed for farmers. The "Department of Agriculture, the various state experimental stations financed jointly by the federal government and the state, and the four great regional agriculture laboratories furnish abundant and conclusive proof of the benefits of government research." Wallace argues that technical information for every business and institution should be made available through technical-information offices in each state.

Similarly, in the interest of full employment at home and rising living standards throughout the world, Wallace believes that

we should play our part in making available modern science and modern tools and equipment everywhere. "The industrial revolution as yet has brought very few benefits, if any, to the great bulk of two billion people in the world. . . . . Three-quarters of the world's peoples make little use of machinery in city industry or on farms." This process of development all over the world can, if wisely managed, make its contribution to opportunities for investment of American funds and the work of American hands and brains.

But in developing foreign-investment outlets we must take care to avert disaster by becoming "bigger buyers of the goods of other countries than we were before the war. . . . To escape a repetition of the disasters of the twenties and thirties, we must build up the national policies and the arrangements that will make foreign trade a permanent two-way street—not a temporary detour to a precipice."

A notable service is performed in this book in calling attention to the grave deficiencies in the American scene. "In 1940, there were around 1,200 counties containing more than 15 million people which had no hospitals at all." Only 60 per cent of our 3,000 counties have organized public health services, and most of these are inadequate. About 2 billion dollars of new hospital construction and facilities are needed, according to estimates of Surgeon General Parran. About a million continuing jobs, including doctors, nurses, technicians, and assistants, would be needed to keep the hospitals going. "Assuring such medical and hospital care to everyone is more important than building roads, constructing dams or saving soil. No price is too high to pay for a healthy, vigorous and productive people."

Our grave deficiencies in education and housing are briefly but vividly presented. While only the bare essentials of our vast housing deficiencies are stated here, they "merit constant repetition because so many in the upper half of our population actually do not fully realize how much less juvenile delinquency, disease and crime there is in modern housing projects compared with conditions in adjoining slum areas." Moreover, a long-range planning of housing construction is necessary to attain greater stability in all of the construction industry.

Some interesting figures are presented with respect to invest-

ment and employment opportunities in river-valley development, land conservation, forest development, rural electrification, and the private-investment opportunities which these public development projects could open up.

Finally we come to the nub of the problem—the national budget for full employment. Attention is called to the last Budget Message of Franklin Roosevelt, which went beyond the usual presentation of federal expenditures and receipts and presented the nation's budget as a whole. "The nation's budget is made up of four parts—(1) what consumers receive and spend; (2) what businesses take in and spend; (3) what local and state governments receive and spend; (4) what the federal government receives and spends." The nation's budget is a composite of the budgets of consumers, of business enterprise, and of government—federal, state, and local. The last Roosevelt budget was the forerunner of the production-and-employment budget outlined in the Murray full-employment bill.

Wallace envisages a 200-billion-dollar national budget consisting in a normal year of the following component parts: consumer expenditures, 135 billion dollars; business capital formation, 30 billion dollars; federal, state, and local outlays on goods and services, 35 billion dollars. This budget is not a forecast, but is regarded as a reasonable point of departure for purposes of analysis and discussion. He is fully aware that "the circumstances of any given situation will dictate the best combination of the parts."

With respect to the discussion of taxation, the point to be emphasized is Wallace's unequivocal statement that he doubts the wisdom of meeting the additional social-security benefits by greatly increased pay-roll taxes. "To avoid the deflationary effect of heavy payroll taxes, I believe that a substantial part of social security should be paid for out of the regular federal budget, that is, out of general taxation." Moreover, he believes that taxes have an important balancing function when we face dangers of inflation or deflation. He advises raising and lowering income taxes as well as varying the rate of public expenditure as a means of achieving an economic balance. Wallace is fully aware that a compensatory fiscal program, properly managed, requires at times restriction of expenditure and increase in taxes in order to offset inflationary tendencies. A truly compensatory policy means stimulus or re-

straint, according to the changing requirements of economic stability.

There is a good chapter on the fiscal feasibility of a full-employment program. Here it is stressed that, even from the standpoint of the management of the public debt, it is of the utmost importance to maintain a high income level. A long quotation from Lord Macaulay with respect to the growth of the British national debt in relation to the growth of national income is given as a "timely bit of debt perspective." We have managed to double our national production every 20 years, and Wallace dares to assert that we can reach, not only a 200-billion-dollar Gross National Product in 1950, but a 400-billion-dollar product in 1970.

Wallace would be the first to admit that in this book he has not been able to explore at all adequately the many difficulties involved in carrying through successfully a program of continuing full employment under conditions of economic stability. But neither have any of the rest of us. It is no answer for any of us merely to say that we must learn by experience. We shall indeed learn by experience and we shall achieve greater success as more and more public support is won for a full-employment program. At the same time, it is incumbent upon students of economics and politics to explore to the fullest possible extent the grave difficulties that will confront us. To be sure, it is not only a matter of technical knowledge but also public education and understanding of a program which has in view the general welfare and not the extravagant claims of special-interest groups. Wallace's rich political experience makes him perfectly aware of the difficult political problems involved. Pressure groups will be with us with or without a full-employment program, but it is a reasonable assumption that the general interest of the nation as a whole can be better defended in a full-employment environment in which different economic groups are not compelled to fight bitterly to get for themselves a minimum share of a low national income.

Appendix D

Inflation[1]

AMIDST all the shouting and the tumult, the charges and countercharges, the current statistical record of high production and employment together with a degree of price stability unequaled in earlier wars is, to say the least, striking The physical output of textiles and textile products in April, 1946, was about 162 per cent of 1935 to 1939, manufactured food products about 150, while nondurable manufactures in general were at 164 per cent of the prewar average. More than anything else, this record reflects the steadiness and common sense of the American public. Listening to and reading the alarming and chaos-prophesying assertions of the more extremist radio commentators, news reports, and editorials, together with many untempered allegations of special-interest groups, a foreigner who knows little or nothing about America might well think that the United States is heading straight for an economic Niagara. Yet, amidst all the froth and fury whipped up in the struggle of contending groups, the country has, for the most part, in my judgment, gone about the job of reconversion in a creditable manner.

With certain exceptions the nation has taken in its stride the inevitable postwar labor disputes—bitter and long as some of these have unfortunately been. The steadfastness and balanced judgment of the public generally in the face of disturbing issues has in turn not altogether been lost upon government. While much of President Truman's constructive program has been delayed or blocked, urgent international legislation has been forthcoming, and in the more immediately pressing domestic matters, Congress has at least left enough elbow room for the Administration to carry on. We have not witnessed the spectacle (at least thus far) of just "letting things rip."

After the last war, the lid was off. Starting from the already

[1] *The Yale Review*, Summer, 1946.

highly inflated wartime level, the cost-of-living index rose from 162 (July, 1914 = 100) in November, 1918, to 208 in June, 1920, while wholesale prices rose from 202 in November, 1918, to 248 in May, 1920. Hourly wage rates rose from an index of 162 in 1918 to 234 in 1920, while average weekly earnings in manufacturing rose from an index of 168 in 1918 to 232 in 1920.

Arguments have been made advocating a policy of decontrol all around, and at the same time urging a program of wage stability. Nothing could be more unrealistic, as the above figure for 1918 to 1920 illustrates. The generally successful conclusion of collective-bargaining agreements throughout the country, with an increase in *basic* wage rates which in retrospect will, I think, be regarded as moderate (leaving *average hourly earnings* substantially stable), could never have been achieved except against the background of continued price control and substantial price stability. The wage upheaval from 1918 to 1920 is proof enough of that. Yet this elementary fact seems never to have occurred to those who wanted to get rid of all price control while at the same time professing support for a stable wage structure. And the repercussions in turn of a price-wage inflationary spiral upon strikes and production are not difficult to imagine. Under such conditions no collective bargains with any prospect of stability and survival could be reached. Instead, against the background of substantial price stability we have come through this difficult period of wage negotiation in a reasonably orderly manner and can now settle down to a truly prodigious volume of output of civilian goods.

In the fight against inflation, as indeed in any public policy, awkward but hard facts intrude and not infrequently throw serious monkey wrenches into the machinery. Many things within reason simply must be done even though they conflict with the goal of price stability. It is not possible to be merely logical and consistent. Food relief for starving countries, and even the British loan will contribute to inflationary pressures; but they are nonetheless necessary. The emergency housing program, and some urgently needed public works, cannot be turned down merely because some years hence they would fit so much better into a neatly planned cyclical compensatory program. So also with the wage adjustment. If basic wage rates had not been raised, *average*

hourly wages would have fallen sharply (a consequence of the elimination of premium overtime, shift premiums, etc.). That this could be done without creating an upheaval in industrial relations was probably not seriously believed by responsible business leaders. Nevertheless the hard fact is that the wage rate increases which have been granted, relatively moderate though they be, cannot everywhere be paid without some price increases.

Tough facts such as these do indeed strike blows at rigorous consistency. The reed that does not bend may break. Blind adherence to a doctrinaire and inflexible pursuit of mere price stability will not do. The Administration has shown on the whole a commendable power of adaptation. While sticking with bulldog tenacity, in the face of bitter opposition, to the stabilization program, it has nonetheless recognized that adjustment and compromise are within limits necessary.

The theory underlying an extension of the OPA until July, 1947, was based on the thesis that by that time the wave of inflationary pressures will begin to recede, and so the protecting dikes may accordingly for the most part be removed. Apart from attempting to appraise the precise date, there is probably no one who will disagree that by that time we shall have made good a large part of the accumulated shortages, that military expenditures will have been cut to a minimum, and that a budgetary balance or even surplus will be possible. But there are many who will assert that the inflationary tide will nonetheless not recede, or at least not appreciably; that the foundations have already been laid for an inevitable price inflation of considerable magnitude even though major shortages have been overcome and a budgetary equilibrium has been reached. From this point of view the OPA is only engaged in a rear-guard delaying struggle against an invincible foe.

The battle, it is alleged, has already been lost. For this two fundamental reasons are assigned. The first is that we have already allowed, by reason of the war and postwar wage policy, the *costs* to rise to a point at which production cannot go forward with the necessary margin of profit unless a new plateau of prices is reached. The second is that wartime financing has left us the heritage of a supply of money and other liquid assets so vast that nothing can stop the rising sea of inflation until the price level has settled at a new high level commensurate with the enlarged

money volume. According to this point of view, neither the conquest of the temporary shortages nor any realizable fiscal and monetary controls can now or later prevent an inflation.

The issues thus raised, basic and far-reaching, are, I think, particularly worthy of discussion. If true, the Herculean efforts of the OPA, weakened by emasculating amendments, are scarcely worth while; indeed they might be regarded as preventing a quick and necessary structural adjustment to the new inevitable price level required by the changed underlying conditions. On the other hand, if these views are false, as I firmly believe them to be, the sooner they are banished, the better we shall be prepared to undertake the problem of economic stability, both for the emergency ahead and for the longer pull. The haunting fear that in the end we shall fail anyway has already weakened the mettle of many a friend of the stabilization program.

Before addressing ourselves to the longer run issues, it is necessary to take note of possible impending developments in the event that, operating under hampering restrictions, the OPA fails to hold the line. Substantial jumps in food and clothing prices would let loose more labor unrest, new strikes, and demands for increased wages. This would indeed put those business leaders who had clamored for crippling OPA amendments on the spot. Many employers might find it difficult to continue to operate under collective agreements outmoded by large increases in the cost of living. Union officials would be confronted with a difficult problem of membership discipline. A labor upheaval of threatening proportions would certainly be under way by early 1947 when new wage contracts will again be up for consideration.

I will not try to answer the question whether in fact the OPA can hold the line during the "restocking boom" immediately ahead. That depends mainly upon the extent to which the country backs up the whole stabilization program. Nor will I attempt to judge whether the temporary emergency (as I regard it) will indeed largely be over by July 1, 1947. I cannot help feeling uneasy that the Administration has found it necessary to go a little too far in giving blanket assurances on this point. In the uncertain world in which we live, it is impossible for anyone to say now how rapidly the emergency will pass. We can bring the budget under control, but the accumulated shortages are another matter.

I shall not in this article make any attempt at a forecast. But I shall try to show why I believe the condition is a temporary one.

Let us consider briefly the character of the inflationary pressures that we will have to contend against. In the first quarter of 1946, total consumer spending was at the annual rate of 120 billion dollars; government expenditures for goods and services at 43 billion dollars and private gross capital outlays at the rate of 19 billion dollars. Rapid shifts are now in process Consumer spending is rising and even under continued controls is likely to reach around 125 billion dollars in the fiscal year 1947 (beginning July 1, 1946, and ending June 30, 1947). Government outlays are being curtailed at a rate exceeding the percentage rate of decline after World War I. It is now believed that a budgetary surplus can be produced in fiscal 1947. Accordingly, all the gross savings of business and individuals would become available for capital formation.

In the following table, figures are set down comparing the annual rates of expenditures by consumers in the first quarter of 1946 and the fourth quarter of 1945 with expenditures in the peak peace quarter of 1941.

CONSUMER EXPENDITURES

	1st quarter 1946	4th quarter 1945	3rd quarter 1941
Nondurables	$76.5	$69.5	$42.0
Durables	10.0	8.4	9.7
Services	33.5	33.0	25.5
Savings	19.0	26.4	15.5
Disposable income	$139.0	$137.3	$92.7

Purchases of nondurable consumers' goods, such as clothing and food, are currently running at a record high. More than 55 per cent of disposable income (individuals' income after taxes) was spent in the first quarter of 1946 on nondurables. Not only was the volume at an unprecedented level, but the *ratio* to disposable income was higher than in any peacetime year. Outlays on consumers' durables are rapidly rising and will soon exceed by sev-

eral billions the regular peacetime year, 1941—a year of unparalleled spending on automobiles and household equipment.

The OPA faces the task of holding the line at the points where scarcities are concentrated. If successful, the high disposable income (say around 140 to 145 billion dollars in fiscal 1947) will not be allowed to be dissipated in inflated prices. In other words, there would remain, after expenditures on available durables, nondurables and services, a large amount of saving (perhaps 15 to 20 billion dollars) from individual income. Adding to this the net savings of corporations and current charges to depreciation and other business reserves, there is in reasonable prospect a volume of gross business and individual savings from the 1947 income adequate to finance private capital formation without resort to any inflationary monetary expansion or mass net liquidation of accumulated liquid assets. In view of the prospective balance in the federal budget, gross business and individual savings would all be available for residential building, business investment of all kinds, both replacement and net, and for the financing of net foreign investment. Now if business and individual saving from current income should prove adequate to finance gross investment, no over-all inflation pressure would arise from the side of private capital formation as was the case after World War I. In the above statement, to be sure, we have encountered important *ifs*. But the analysis is nonetheless significant, and the outcome that is suggested is by no means an improbable one.

In the postwar inflationary movement in 1919-1920 consumer demand played only a secondary role. It was primarily an investment boom. Private gross capital formation, mainly in the form of producers' equipment and inventory accumulations, aided by a large export balance, pushed the economy through the roof. Private gross capital formation rose to the abnormally high level of 22 per cent of Gross National Product, while the more normal, noninflationary rate of investment in 1924 to 1928 averaged only 16.5 per cent of the gross product. Investment in producers' equipment in 1919-1920 ran above the high twenties, inventory accumulation averaged 10 times that of 1924 to 1928, and the net export balance was 6 times higher. Much of the expansion was financed on credit. The loan and discounts of national banks increased 35 per cent. Liquid assets were relatively small compared with those

of today, but credit resources were abundant. Relatively small liquid assets proved to be no guarantee against inflation.

Today it is much more the backlog of demand for consumers' durables and semidurables and for housing which threatens price inflation. The upward surge of producers' investment is not likely to reach, relative to gross product, anything like the 1919-1920 bulge. Private gross capital formation today, comparable with that of 1919-1920, would amount to 42 billion dollars per annum. No such level is likely to be approached by a considerable margin. An immense amount of productive facilities was built during the war, a significant part of which will be useful for peacetime needs. Producers' equipment, inventory accumulations, and net exports will indeed run high in absolute terms. But in terms of the huge postwar income, the *ratio* is not likely to be seriously abnormal. If the OPA succeeds in holding consumer prices in line, the volume of current individual and business savings, I repeat, is likely to prove ample to finance all private capital formation—a situation very different from that in 1918 to 1920 when investment far outran savings from current income. If *consumer* spending can by direct control be kept within bounds, the community as a whole (including consumer, business, and government outlays) is not likely to spend on consumer goods, services, and capital goods combined significantly more than the income earned from current production. If this is so, there will be no serious over-all inflationary development.

If saving and investment are in balance, and the federal budget is in equilibrium, the inflationary problem is basically one of controlling *consumer* demand and of directing the available productive resources into the areas where the need is greatest. It is a problem of getting going a *balanced* and *high* level of production in the consumers' goods industries commensurate with the requirements of the greatly increased postwar volume of disposable income. On top of this new high level of normal demand, there is the temporary bunching of deferred demand for automobiles, clothing, housing, etc. And especially with respect to clothing and housing an added difficulty arises because the mass demand is for low-priced goods, while profit margins are highest in the high-priced ranges. To meet this concentrated demand it is necessary by means of controls over prices and inventories, and

by priority and allocation powers, to channel resources into the areas where consumer needs are most pressing. In contrast, free market forces could only have the effect of supplying those who could best afford to bid up prices.

Nor is this a problem that could be met solely by over-all control of aggregate demand. If aggregate demand were reduced by monetary, fiscal, and other over-all measures to a point at which the demand for automobiles and houses, for example, could be matched by supply, we should have to produce a gigantic deflation and reduce employment to a level perhaps as low as that of 1933 or even lower. In somewhat lesser degree the same holds for certain types of food and clothing. The problem is that of specific scarcities piled on top of a new high level of normal current demand. Such a problem can be met only by direct controls. It is true that an excess of *aggregate* demand would intensify the *special* scarcities. Hence the importance of a budgetary surplus and of promoting a volume of current saving adequate to finance private investment. There should be no further tax reduction until the concentrated inflationary pressures have spent their force.

It is the announced policy of modern democratic governments to maintain aggregate demand and aggregate supply in balance in a free market, not by price or other direct controls, but by compensatory fiscal and monetary action. This is the meaning of the various "White Papers" on employment policy. Monetary and fiscal policy, aided by long-term basic programs of expansion, can in large measure offset ordinary peacetime fluctuations in the rate of investment. But in a period of abnormal war-created scarcities, such as that prevailing now, indirect monetary and fiscal controls are not adequate. Under such conditions, unless the concentrated demands are kept under *direct* controls, a general inflationary movement is inevitable.

There is a special reason why it is important to hold spending in the concentrated areas in check during the period of abnormal war-created scarcities. The emergency period is peculiarly one of pent-up demand in special areas. If this warped structure of demand were allowed to work itself out under free market forces, a distortion would inevitably result not only in the price and cost structure, but also in the allocation of productive resources. Ex-

cess employment and investment would be drawn into the areas of concentrated demand. This would produce geographical and occupational dislocations, a distortion in the wage structure, and ultimately excess capacity in certain industries. After the emergency period had passed, a secondary "reconversion," to the more normal peacetime demand would then become necessary. These distortions would set going replacement waves which would remain to plague the economy. Thus in order to reach a balanced production as rapidly as possible, it is of the utmost importance that free market forces shall not be permitted to transmit the postwar artificial structure of demand into a distorted structure of production. Those who desire a balanced return to a normally functioning market economy should favor direct controls during the period of artificial scarcities.

Equally important is a program to reach during the transition period as nearly as may be a balance in the cost-price structure, especially the ratio of wages to profits. While it is perfectly true that inflationary tendencies in the consumers' markets could be lessened by holding wages below the equilibrium rate, an abnormally large margin of profits would have inflationary consequences in the real-estate and speculative markets. This is not the way to move into a balanced peacetime economy. The outcome sooner or later would be a collapse of security and real-estate prices with attendant repercussions upon the whole economy. Moreover, if wages are not raised to the equilibrium level commensurate with high capacity utilization and man-hour productivity, we should come out of the transitional restocking period with a lack of balance in the ratio of wages to total national income. If wages are not in a balanced relation to national income, it will not be possible to find markets for the potential output of consumers' goods industries. The inevitable effect would be deflation and unemployment.

I turn now to the first long-run issue—the level of costs and its effect on the price level. If an inflationary movement is allowed to develop, the new high level of costs, notably wages, is likely to leave the economy on a permanently higher price plateau. This is true even though a major price collapse follows the inflationary peak. This, indeed, is what happened both with respect to the Civil War upheaval and even more after World War I.

The whole inflationary movement in World War I, including the postwar restocking spurt of 1919-1920, carried the wage level to a new high plateau considerably more than double the prewar level. The collapse of 1921-1922 made only a slight dent in the new wage level, and by 1923 the wage index was back around the war peak. Wages constitute the backbone of the cost structure. The wage level, or more precisely *labor cost,* is the pivot around which the whole price structure oscillates and revolves. Once labor costs have been pushed up into a new high plane, the price-making process erects a new structure of prices around this central core.

This, I think, is the basic explanation for the new plateau of prices after World War I. Wage rates (1914 = 100) had risen to an index around 220 in 1923 and to 230 in 1926. But man-hour productivity, while stationary in the war years, suddenly increased 30 per cent from 1919 to 1922 and to 53 per cent above 1919 by 1926. Thus the new level of *labor cost* (wage rates corrected for productivity) rose to a new plateau about 50 per cent above the prewar. Accordingly, the new level of wholesale prices of finished products was adjusted to the new basic cost level and settled at an index approximately in line with the new labor cost.

Should we yield in the next year or two to the temporary inflationary pressures and permit a cycle of price and wage increases until the wage structure had risen to a new plateau, lifting *labor costs* (productivity increases considered) to a drastically higher level, then a new price plateau far above the current one would likely be established as an aftermath after the inflation had run its course precisely as occurred after World War I.

Such a structural shift in the price level, quite apart from the disturbance of the inflationary upheaval itself, has serious and long-lasting consequences. The accumulated wartime savings would in large part have been dissipated during the inflationary period in an effort to keep up with the rising cost of living. Those that remained would have lost much of their purchasing-power value. Such a result occurring under the impact of *laissez faire* and uncontrolled market forces would represent an abdication of responsible government in one of its most vital functions—the maintenance of monetary integrity, the preservation of the value of money.

Accordingly, a primary reason for doggedly adhering to price

stability is to prevent a wage upheaval from which it is impossible to recede and which would leave us high and dry on a new price plateau. But, it will be asked, have we not already permitted wage advances that put us on a new *labor cost* level—one that requires substantial increase in the price level?

The precise wage and man-hour productivity data requisite for a complete answer to this question are not yet available. Yet certain broad conclusions appear to be warranted. Judging from the experience after World War I, large increases in man-hour productivity may be expected in the next 2 or 3 years. Unit fixed costs, with larger output volume, are much lower than in 1936 to 1940. Recent basic wage increases are roughly offset by the elimination of overtime and shift premiums and by down-grading, leaving *average hourly earnings* substantially stable. Since the end of the war, wherever industries have resumed normal operation corporate profits are in general highly favorable, as is shown by financial statements. The repeal of the excess-profits tax permits industry to shift a part of gross earnings from government to labor without encroachment upon its own net earnings after taxes. All in all, it is not evident that labor costs have advanced to a point that compels an adjustment to a higher price plateau.

I now address myself to the second long-run issue. Has the wartime financing created a monetary condition which makes a new price plateau, substantially above the current level, inevitable?

This thesis, so far as I have been able to discover, is usually rather loosely stated in terms of (1) the vast increase in the quantity of money (including currency in circulation, demand deposits, and savings deposits) and (2) the vast increase in the holdings of government bonds.

The first point—the increase in the money supply—must be appraised against the background of various factors. The money volume has no meaning or significance by itself as an absolute figure. It must be related to other magnitudes, such as the Gross National Product and the national income, and to historical trends in these relationships. It must also be assessed in terms of the distribution of these cash holdings. Thus viewed, I submit that there is no convincing evidence that the existing or probable impending money supply (assuming reasonably competent man-

agement) will be excessive once we have gotten over the temporary emergency.

The second point relates to the volume of liquid savings in government securities. Here there are several matters of paramount importance: One relates to the probable volume of future savings out of current income and its impact upon the continued holding of past accumulations, and, conversely, the effects of past accumulations of savings upon the level of spending out of current income; another relates to the distribution of the holdings and the character of the ownership; a third relates to past experience especially with respect to probable shifts in holdings under varying conditions, particularly with respect to any tendency to monetize the public debt. A consideration of these matters leads again, I am convinced, to the conclusion that once the temporary restocking boom is over, there is no valid ground for believing that these accumulated savings must inevitably yield a substantially higher price plateau.

How are we going to escape disaster in view of the vast increase in our money supply? First let it be noted that the crude quantity theory is not only quite invalid but moreover such relation as may exist between the quantity of money and prices is indirect and tenuous. Moreover, the quantity theory in its more refined versions would itself postulate that a substantial increase in money is required by reason of the doubling in recent years of the Gross National Product.

We may define the money supply as equal to the demand deposits and currency held by the public (interbank and United States government deposits excluded). If we wish, we may include also time deposits. Using the more inclusive concept, the money supply increased from 66 billion dollars in June, 1940, to 143 billion dollars in June, 1945. But in the meantime Gross National Product had risen from 97 billion to 197 billion dollars. So defined, the money supply represented 68 per cent of Gross National Product in 1940 and 72 per cent in 1945. If we omit time deposits, we find that the demand deposits and currency held by the public increased from 39 billion dollars in June, 1940, to 94 billion dollars in June, 1945. The money supply thus defined amounted to 40 per cent of national product in 1940, and to 48

per cent in 1945. Thus the *relative* increase in the money supply is not great.

Assuming substantial price stability, Gross National Product by 1947 may be slightly below the 1945 level. It is also true that the money supply has risen (early 1946) above the mid-1945 figure to around 152 billion dollars if time deposits are included and to 102 billion dollars if these are excluded. Taking this latter concept, the money supply as defined might be set down as not improbably reaching about 52 per cent of Gross National Product by 1947.

In view of the fact that the federal budget is rapidly moving into balance with the prospect of a surplus in the fiscal year 1947, the money supply is not likely to change substantially in consequence of Treasury operations. The general fund balance is now being reduced largely to retire securities held by the commercial banks. We are rapidly moving into a budgetary surplus. There is good prospect that the liquidation of savings bonds will be more than matched by new purchases. Thus in the first quarter of 1946 redemptions amounted to 1,825 million dollars but new purchases amounted to 2,378 million dollars. Large continued purchase of government securities is in prospect by insurance companies, savings banks, and government trust funds. The volume of these purchases will probably more than take care of any unloading by business corporations and individual investors. This would permit some further retirement of securities held by the commercial banks, and so a reduction in deposits. Nor is there any convincing evidence that commercial loans will increase in view of the already large liquid assets of corporations and unincorporated business. Responsible monetary management must indeed ensure that the commercial banks shall not unload securities on the Federal Reserve Banks for the purpose of building up excess reserves as a basis for unwarranted credit expansion. The monetary authorities are alert to the problem and a pragmatic solution suited to American conditions may be reasonably expected. The informal promotion of banking practices resulting in generally accepted canons of good banking behavior may be a workable procedure preferable to some of the more rigid proposals that have been made. The voluntary arrangement recently entered into between the Bank of Canada and the private banks is in-

structive. All in all, with responsible monetary management any continuing and unwanted increase in the money supply in the United States is not in prospect.

Not only is far more money needed for current and prospective transaction purposes than prewar, in view of the vast increase in Gross National Product and national income, but in addition the desire to hold a large part of one's assets in the form of money rises with growing wealth and income. Thus, historically, as the national income has risen throughout the last century, business and individuals have wished to hold an ever-increasing amount of money in relation to income.

Since the figures for Gross National Product are not available, it is necessary, in taking a historical view, to relate money supply to national income. In 1840 the public held 10 cents of deposits and currency per dollar of national income; 20 cents by 1870; 55 cents by 1900; 65 cents by 1925; 85 cents by 1940; and currently around 95 cents. If time deposits are excluded, the figures would of course be much smaller, time deposits constituting (currently) around one-third of the total money supply.

Thus the record indicates that with growing wealth and prosperity, the public has wished to hold an ever-increasing amount of money in relation to income. This historical tendency is an inherently reasonable one. The crude notion that any increase in the money supply will produce a price inflation is wholly untenable; more than that, the total money supply can and has increased over time far more rapidly than real income without producing inflationary consequences. Recent increases are not substantially out of line with the historical upward trend of the ratio of money to national income.

I would be the first to disclaim that these figures tell us what is currently an appropriate money supply. Any such conclusion would be superficial and indefensible, and would represent a new form of crude quantity theory. Current development can, however, be more accurately appraised against the background of a long-run historical trend.

Surveys of liquid-asset holdings made by the Department of Agriculture indicate that the lower income half of the population has accumulated relatively little. Thus in Birmingham, Ala., about 60 per cent of the respondents had acquired less than 20

per cent of the war bonds held by the group; in Douglas County, Ill., 50 per cent of the urban respondents had acquired only 15 per cent, and a similar proportion of the farmers questioned had acquired little more than 20 per cent of the bonds purchased by the group. Such disparities in holdings will not surprise anyone who has studied even a little into the distribution of wealth and income.

The surveys, so far as they go, tend to show that the accumulated wartime savings are firmly held. There is no indication of a tendency to spend recklessly. The same conclusion was reached in the savings survey published by *Fortune*. An interesting point is that *within each income class,* whether high or low, the savings are concentrated in a relatively small group who may be regarded as "natural savers." This fact again tends to support the thesis that the savings are firmly held.

Of the total of 276 billion dollars of government securities outstanding in March, 1946, 176 billion was held by insurance companies, savings banks, commercial banks, Federal Reserve Banks, trust funds, and public agencies. Around 100 billion dollars was held by business and individuals. Some 35 billion dollars was held by business, while around 35 billion dollars were savings bonds of the kind widely held by the mass of the population of which, however, a considerable fraction was held by the well-to-do. The vast holdings by financial institutions, government agencies, and trust funds serve to insulate nearly two-thirds of these liquid assets from the commodity markets. Thus the manner in which the bonds are held, in contrast with the total volume, profoundly changes the inflationary picture.

It is of course true that if commercial banks hold large amounts of securities, the public must hold correspondingly large amounts of deposits and currency. Individuals hold about 45 billion dollars of savings deposits, around 25 billion dollars of demand deposits, and about 21 billion dollars of currency. Business (nonfinancial) holdings of time and demand deposits amount to around 40 billion dollars. Some transfer of government securities from the commercial banks to individuals and business, as we have noted above, is not improbable, and this would reduce the monetary holdings of the public. If the public wishes to change the composition of its holding of liquid assets in this manner, well and

good. But it would be a mistake to assume, as some have, that such a development would have much significance with respect to the problem of inflation. Securities held by the public could at any moment be converted back into cash whenever there was the will to purchase consumers' or capital goods. This is the real problem. And it is very little affected by the particular form in which the liquid assets are held. In this connection it is also well to remember that the sale of bonds to banks is no more inflationary than an increase in commercial loans.

In what I have said above, I do not mean to deny that large liquid assets tend to increase private spending whether for consumption or investment Many individuals will indeed use up a part of their liquid assets. Many more, safeguarded by accumulated savings, will feel freer to spend out of current income. All this is true. Nevertheless, a mere recital of the *volume* of liquid assets, without regard to their *distribution,* is very misleading and leads to exaggerated and unwarranted alarmist views. I have tried to present a more balanced picture. Such inflationary pressures as will flow from the liquid assets are, I believe, manageable by (1) maintenance of a high rate of *taxation,* (2) a budgetary surplus, (3) debt management, with special reference to bank holdings, and (4) a continued program of *saving* from current income. In other words, over-all monetary and fiscal policy, once the concentrated consumer scarcities have been overcome, can keep aggregate demand from outrunning our productive capacity.

In the immediate future inflationary pressures can be controlled by a budgetary surplus and by price and other direct controls. For the longer run, the danger is much more that we shall be confronted with inadequate aggregate demand in view of our vast productive potential. To help solve this problem a large volume of liquid assets will stand us in good stead as a cushion against deflation and depression. The United States, once we work our way through the current scarcities, is not an inflation-sensitive country. It is significant that at high income levels, individuals and corporations save a high percentage out of current income. This fact implies a high capacity to hold savings already accumulated. A country with a vast capacity to save is not in great danger of inflation. This country has moreover demonstrated its great taxable capacity. Our tax record during the war, by and large,

represents a creditable performance, The wartime tax structure, and that now on the statute books, indicates a determination to follow a responsible fiscal program. There will indeed be pressures for a too early tax reduction, and we need to be wary to resist these pressures. Yet, while the recent tax reduction probably went a little too far, it cannot be denied that on the whole Congress has acted in a reasonably responsible manner. This country has moreover an incredible capacity to produce goods and commodities of almost every description, whether it be agricultural commodities, the wide range and infinite variety of consumers' goods, or heavy capital equipment, machinery and machine tools. From the long-run standpoint, considering our vast capacity to produce, together with our high propensity to save out of current income, we are in far greater danger of inadequate markets than of runaway inflation. Such a country is capable of preserving its accumulated liquid savings as a great pool of financial security against unforeseen contingencies. Countries on a low margin of subsistence and with low productive capacity are incapable of holding large liquid assets. Their historical inflationary experiences have no relevance for a country so rich and so productive as the United States.

We have come through the war without any substantial price inflation. In the late thirties the price level of agricultural products was abnormally low—a function of a low level of urban employment and purchasing power. It is now too high, and can be expected to settle down to a more balanced position in the general structure of prices once the current food shortages are overcome. The purchasing power of money is only slightly below the pre-depression level of the twenties. Having come through the war with substantial price stability, it is incredible that we should lightly dissipate our accumulated wartime savings by permitting a fall in the purchasing power of money.

To preserve the integrity of our money, seven policies are necessary: (1) continuation of price control until we have overcome the temporary scarcities, (2) rapid increase in the production of houses, consumers' durables, and clothing, (3) a balanced adjustment of wages to man-hour productivity without pushing wage rates so high as to raise labor cost and necessitate a general over-all increase in prices, (4) continued high taxation, (5) continued pro-

gram of saving by the entire population with special emphasis on the purchase of savings bonds, (6) application by the Treasury of funds derived from excess tax revenues or sale of bonds to the public in excess of the redemptions, to the retirement of government securities held by the commercial banks, (7) arrangements ensuring that commercial banks shall not abuse their access to Federal Reserve credit and thus build up excess reserves as a basis for unwarranted monetary expansion.

The rule of fiscal flexibility is necessary to maintain a balance between aggregate demand and aggregate supply. The dogma of a balanced budget rarely fits the requirements of economic stability. So long as the present period of inflationary pressures lasts, an *over*balanced budget should be reached as rapidly as possible. But the restocking boom will sooner or later turn into a slump. The government should announce now its intention to follow boldly a program of fiscal flexibility.

Such a declaration was made by the Canadian Government in the Dominion-Provincial Conference of August, 1945, in the following forthright manner: "In periods of declining business activity, arising perhaps from depressions abroad, it is proposed that these expenditures [detailed in an early paragraph] will be boldly expanded. Tax rates must be reduced at the same time, but whether this is done or not revenues will obviously fall off sharply and large deficits will result. The Government is not only prepared to accept these but will deliberately plan for them in periods of threatened depressions in order to give the economy a stimulus and relieve unemployment." This declaration with respect to depression policy, let it be remembered, was made by a government that has demonstrated a high degree of fiscal responsibility in the control of inflation during and after the war.

In the impending inflationary period, however long it may last, increasing reliance should be placed on an over-all monetary and fiscal policy to hold aggregate demand in a balanced relation with aggregate supply; there should be a progressively diminishing reliance on the OPA. But we must not assume that prosperity will last forever. And it is now that the public needs to be educated to think in terms of a flexible fiscal policy—one that is prepared to cope with both inflation and deflation.

Appendix E

Employment Act of 1946

AN ACT

To declare a national policy on employment, production, and purchasing power, and for other purposes.

SHORT TITLE

Section 1. This Act may be cited as the "Employment Act of 1946."

DECLARATION OF POLICY

Section 2. The Congress hereby declares that it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and cooperation of industry, agriculture, labor, and State and local governments, to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power.

ECONOMIC REPORT OF THE PRESIDENT

Section 3. (a) The President shall transmit to the Congress within sixty days after the beginning of each regular session (commencing with the year 1947) an economic report (hereinafter called the "Economic Report") setting forth (1) the levels of employment, production, and purchasing power obtaining in the United States and such levels needed to carry out the policy de-

clared in Section 2; (2) current and foreseeable trends in the levels of employment, production, and purchasing power; (3) a review of the economic program of the Federal Government and a review of economic conditions affecting employment in the United States or any considerable portion thereof during the preceding year and of their effect upon employment, production, and purchasing power; and (4) a program for carrying out the policy declared in Section 2, together with such recommendations for legislation as he may deem necessary or desirable.

(b) The President may transmit from time to time to the Congress reports supplementary to the Economic Report, each of which shall include such supplementary or revised recommendations as he may deem necessary or desirable to achieve the policy declared in Section 2.

(c) The Economic Report, and all supplementary reports transmitted under subsection (b), shall, when transmitted to Congress, be referred to the joint committee created by Section 5.

COUNCIL OF ECONOMIC ADVISERS TO THE PRESIDENT

Section 4. (a) There is hereby created in the Executive Office of the President a Council of Economic Advisers (hereinafter called the "Council"). The Council shall be composed of three members who shall be appointed by the President, by and with the advice and consent of the Senate, and each of whom shall be a person who, as a result of his training, experience, and attainments, is exceptionally qualified to analyze and interpret economic developments, to appraise programs and activities of the Government in the light of the policy declared in Section 2, and to formulate and recommend national economic policy to promote employment, production, and purchasing power under free competitive enterprise. Each member of the Council shall receive compensation at the rate of $15,000 per annum. The President shall designate one of the members of the Council as chairman and one as vice chairman, who shall act as chairman in the absence of the chairman.

(b) The Council is authorized to employ, and fix the compensation of, such specialists and other experts as may be necessary for the carrying out of its functions under this Act, without regard

to the civil-service laws and the Classification Act of 1923, as amended, and is authorized, subject to the civil-service laws, to employ such other officers and employees as may be necessary for carrying out its functions under this Act, and fix their compensation in accordance with the Classification Act of 1923, as amended.

(c) It shall be the duty and function of the Council—

(1) to assist and advise the President in the preparation of the Economic Report;

(2) to gather timely and authoritative information concerning economic developments and economic trends, both current and prospective, to analyze and interpret such information in the light of the policy declared in Section 2 for the purpose of determining whether such developments and trends are interfering, or are likely to interfere, with the achievement of such policy, and to compile and submit to the President studies relating to such developments and trends;

(3) to appraise the various programs and activities of the Federal Government in the light of the policy declared in Section 2 for the purpose of determining the extent to which such programs and activities are contributing, and the extent to which they are not contributing, to the achievement of such policy, and to make recommendations to the President with respect thereto;

(4) to develop and recommend to the President national economic policies to foster and promote free competitive enterprise, to avoid economic fluctuations or to diminish the effects thereof, and to maintain employment, production, and purchasing power;

(5) to make and furnish such studies, reports thereon, and recommendations with respect to matters of Federal economic policy and legislation as the President may request

(d) The Council shall make an annual report to the President in December of each year.

(e) In exercising its powers, functions and duties under this Act—

(1) the Council may constitute such advisory committees and may consult with such representatives of industry, agriculture,

labor, consumers, State and local governments, and other groups, as it deems advisable;

(2) the Council shall, to the fullest extent possible, utilize the services, facilities, and information (including statistical information) of other Government agencies as well as of private research agencies, in order that duplication of effort and expense may be avoided.

(f) To enable the Council to exercise its powers, functions, and duties under this Act, there are authorized to be appropriated (except for the salaries of the members and the salaries of officers and employees of the Council) such sums as may be necessary. For the salaries of the members and the salaries of officers and employees of the Council, there is authorized to be appropriated not exceeding $345,000 in the aggregate for each fiscal year.

JOINT COMMITTEE ON THE ECONOMIC REPORT

Section 5. (a) There is hereby established a Joint Committee on the Economic Report, to be composed of seven Members of the Senate, to be appointed by the President of the Senate, and seven Members of the House of Representatives, to be appointed by the Speaker of the House of Representatives. The party representation on the joint committee shall as nearly as may be feasible reflect the relative membership of the majority and minority parties in the Senate and House of Representatives.

(b) It shall be the function of the joint committee—

(1) to make a continuing study of matters relating to the Economic Report:

(2) to study means of coordinating programs in order to further the policy of this Act; and

(3) as a guide to the several committees of the Congress dealing with legislation relating to the Economic Report, not later than May 1 of each year (beginning with the year 1947) to file a report with the Senate and the House of Representatives containing its findings and recommendations with respect to each of the main recommendations made by the President in the Economic Report, and from time to time to make such

other reports and recommendations to the Senate and House of Representatives as it deems advisable.

(c) Vacancies in the membership of the joint committee shall not affect the power of the remaining members to execute the functions of the joint committee, and shall be filled in the same manner as in the case of the original selection. The joint committee shall select a chairman and a vice chairman from among its members.

(d) The joint committee, or any duly authorized subcommittee thereof, is authorized to hold such hearings as it deems advisable, and, within the limitations of its appropriations, the joint committee is empowered to appoint and fix the compensation of such experts, consultants, technicians, and clerical and stenographic assistants, to procure such printing and binding, and to make such expenditures, as it deems necessary and advisable. The cost of stenographic services to report hearings of the joint committee, or any subcommittee thereof, shall not exceed 25 cents per hundred words. The joint committee is authorized to utilize the services, information, and facilities of the departments and establishments of the Government, and also of private research agencies.

(e) There is hereby authorized to be appropriated for each fiscal year, the sum of $50,000, or so much thereof as may be necessary, to carry out the provisions of this section, to be disbursed by the Secretary of the Senate on vouchers signed by the chairman or vice chairman.

Index